

# African Development Bank



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## **PROPOSAL FOR A REVISION OF LOAN PRICING FOR SOVEREIGN AND SOVEREIGN-GUARANTEED OPERATIONS**

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**The loan pricing proposal was prepared by an inter-departmental task team listed below:**

**Loan Pricing Task Team Members:**

K. Diallo	Director, Financial Management, Chair
J.B.Bile	Office of the Vice President, Finance
C. Boamah	Director, FFCO
P. Kei-Boguinard	Division Manager, FFMA, Vice Chair
T. de Kock	Division Manager, FFMA, Vice Chair
O. Hollist	Division Manager, FFCO
J. Ahogny,	Division Manager, FFCO
A. Bellier, Jean	Principal Risk Officer, FFMA
N. Ahononga	Risk Officer, FFMA
A. Coulibaly	Risk Officer, FFMA
O. Fall	YPP, FFMA
S. Tape	Treasury Officer, FTRY
O. Eweck	Investment Officer, FTRY
P. Godfred	Lead legal, GECL
P. Toko	Budget Officer, COBS
R. Bharat	Investment Officer, OPSM

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### Glossary

**NB- The analysis provided in this report is based on the best information available at the time of the review.**

## LIST OF MAJOR REVISIONS AND UPDATES

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The list below summarizes all the changes made since the original version was discussed during the informal Board of Directors on February 2010.

*All changes in the revised document are highlighted in blue.*

- The third principle has been enhanced to factor in the need to keep borrowers engaged with due regard to their financial constraints (*Executive Summary page 8 & Section 4 pages 18-20*).
- Measure 2 has been revised to take into consideration the various consultations held on the subject matter with Executive Directors (*Executive Summary page 8 & Section 5 pages 24 & Conclusion page 28*).
- The reference to a possible waiver for Measure 4 has been deleted (*Footnotes 2 and 18*).
- The Comparators benchmarking has been updated as of March 2010 (*Section 3 table 02, paragraphs 3.6 & 3.11, Section 5 table 06*);
- All figures and tables related to year-end 2009 have been updated to reflect the audited financials.
  - The Public sector portfolio structure by product has been updated as of December 2009 (*Section 2 table 01 & paragraphs 2.15 & 2.16*);
  - 2009 figures have been updated according to actual versus budget (*Paragraph 5.3, figure 1, 2, 3a and 3b, table 05 and Annex 3 table A*);
- Projections have been revised and are in line with those presented in the GCI document (*Section 5 paragraphs 5.6 to 5.9 and 5.16 to 5.18, figures 2, 3a and 3b, table 05 and Annex 3 table B, Annex 4, addition of footnote 15*);
- Annex 3 has been expanded to provide details on the projected coverage ratios (*new table A2 & new graph*).
- Annex 3 has also been revised to factor in a possible revision in the cost sharing formula and the new projections (*Table B*).

## LIST OF ABBREVIATIONS

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ADB	African Development Bank
ADF	African Development Fund
AsDB	Asian Development Bank
CSP	Country Strategic Paper
DFI	Development Financial Institution
ESW	Economic Sector Work
EVSL	Enhanced Variable Spread Loan
FSL	Fixed Spread Loan
GCI	General Capital Increased
IADB	Inter American Development Bank
IBRD	International Bank for Reconstruction and Development
LIBOR	London Interbank Offered Rate
LIC	Low Income Country
MDB	Multilateral Development Banks
MIC	Middle Income Country
RMC	Regional Member Country
UA	Unit of Account
VSL	Variable Spread Loan

## EXECUTIVE SUMMARY

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During the course of the GCI-VI discussions certain shareholders have requested a review of the Bank's loan pricing terms, to ensure consistency with the shared objective of assuring the long-term financial sustainability of the Bank. This review focuses on the pricing of sovereign-guaranteed loans only, as the pricing of non-sovereign guaranteed (i.e. private sector) loans are risk-based and market-driven and do not currently raise any major concern for shareholders.

The context for this review comprises several mutually reinforcing considerations. As a result of its co-operative nature, the Bank charges the same spread for all its sovereign-guaranteed loans. In other words, the Bank does not apply risk-based pricing for sovereign-guaranteed loans. At the same time, such uniform pricing should contribute towards the year-to-year internal resource generation capacity, thereby supporting the growth of the Bank's development assistance activities (comprising lending and non-lending activities, including contributions to development initiatives). Further, by contributing to the longer-term financial sustainability of the Bank, loan pricing also helps to assure the Bank's "AAA" rating, which in turn enables the Bank to borrow funds at highly attractive rates on the capital markets. This will ensure the efficiency of the Bank's intermediation role.

Also, it is important to note that a key assumption underpinning many of the Bank's pricing considerations (as well as those of most other MDBs) was that MDBs would always be able to obtain funding at levels below Libor (sub-Libor). The recent financial crisis has highlighted that this may not always be the case in times of systemic stress and that the refinancing and liquidity risks associated with some of the Bank's loan products could be higher than initially anticipated. Such risks could impact negatively the Bank's income generation capacity.

For the above reasons all the shareholders of the Bank, borrowing and non-borrowing, have a keen interest in assuring the adequacy of the Bank's loan pricing terms.

The loan pricing framework is anchored to the Agreement Establishing the Bank. Articles 17 and 18 of the Agreement stipulate that: (i) interest rates and charges should be reasonable; (ii) the Bank shall receive suitable compensation for risk; (iii) terms and conditions shall take due account of the terms and conditions on which the corresponding funds were obtained by the Bank (i.e. a cost of funds-plus basis); and (iv) the Bank should apply sound banking principles.

Consistent with such framework and taking into account the nature and mandate of the Bank which is not a profit maximizing institution, Management in making proposals related to the pricing of loans continues to be guided by the following principles:

- First, loan charges should be reflective of the true cost of funding;
- Second, they should be adequate to cover structural costs associated with the Bank's operations (i.e. lending related expenses), bearing in mind considerations of efficiency in the management of expenses;

- Third, they must have embedded flexibility for absorbing average expected losses over the lifetime of the loan and recover capital costs [with due regard to borrowers financial constraints](#);
- The fourth important feature is competitiveness with comparable institutions/or the market and ability to support portfolio growth;
- The fifth component is predictability and transparency.

In the light of the above, Management undertook a comprehensive review of the Bank's loan pricing structure taking into consideration the key requirements and guiding principles of sustainable pricing, recent developments in comparable institutions, the specific needs of the RMC borrowers [and the incentive of keeping them engaged with the Bank](#), within the context of the mutually reinforcing considerations summarized above.

The proposals presented in this paper may be classified [into](#) two broad categories, as follows: (i) measures to provide reasonable flexibility to the Bank to adjust to changes in the major drivers of the cost of doing business without compromising transparency and predictability; and (ii) pricing adjustments to address specific inadequacies in the current pricing structure [without jeopardizing competitiveness](#).

#### **MEASURES TO ADDRESS THE PRINCIPLE OF LOAN PRICING FLEXIBILITY**

The measures proposed below are subject to Board approval, as is customary, and are also intended to be applied prospectively only.

- **Measure 1 – Periodic review of the adequacy of the lending spread for new loans**

A review of the adequacy of the lending spread for new loans should be performed within the framework of the Medium Term Financial Outlook of the Bank. If the lending spread does not cover 100% of operational expenses - which will be a trigger mechanism-, Management will make a formal proposal of adjustment to the Board, if deemed necessary.

- **Measure 2 - Revision of loan pricing for exceptional stress events**

[As part of the range of measures that Management and the Board may take to protect the Bank's balance sheet and financial integrity and to maintain its credit AAA rating, in response to \*\*exceptional unforeseen stress events\*\*, an upward adjustment of the price of loans signed after the date of the adoption of this policy could be considered for a \*\*limited time\*\*. The Board of Directors shall approve the qualification of an event as exceptional, the related level of pricing adjustment and application period.](#)

## **SPECIFIC MEASURES TO ADDRESS THE ADEQUACY OF LOAN CHARGE COVERAGE**

- **Measure 3 - Upward adjustment of the lending spread for new loans**

To ensure long term sustainability and based on the financial outlook of the Bank, an upward adjustment of the current spread may be necessary to protect the Bank's balance sheet. Indeed, the projections of the Bank's income over the medium term indicate that the Bank is unlikely to fully recover its operating costs and provisions. Therefore, Management proposes an increase in the current spread by 20 basis points in 2010, which would bring the contractual spread from 40 to 60 basis points. [Such an increase would ensure full coverage of operational expenses after the end of the MTS period \(around 2014\) and the coverage of expected level of provisions by 2017.](#) If in future years the Bank's financial condition improves, a downward adjustment could be considered by the Board to ease the financial burden on borrowers.

- **Measure 4 - Introduction of a Graduated Commitment fee for fast disbursing Policy Based Loans**

Management proposes to introduce a graduated commitment fee on fast disbursing policy based loans ranging from 25 bps to 75 bps. Such graduated commitment fee, applicable only to amounts not utilized within the negotiated loan draw-down timetable, is intended to discourage borrowers, without imposing an undue penalty, from delaying disbursements on loans possibly contracted for precautionary purposes only, thereby using up risk capital that could be available for lending<sup>1</sup>. The fee would commence at 25 bps from the scheduled disbursement date of each tranche and increase by 25 bps every six months thereafter, to a maximum of 75 bps<sup>2</sup>, on any undrawn portion of each tranche.

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<sup>1</sup> The average length of disbursement of Policy Based Loans in ADB's Portfolio is 1.9 years.

<sup>2</sup> 75 bps was the fee applied before the cancellation of commitment fees.

## I. BACKGROUND

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1.1 Over the past few years, Management and the Board have devoted significant time and efforts to the Bank's Medium Term Financial Prospects and net income allocation, focusing largely on the long-term sustainability of the Bank's financial structure. Also, during the July 2009 meeting of the Board of Directors to discuss the Bank's General Capital Increase, Management was requested to examine the adequacy of the Bank's loan pricing within the context of the range of long term strategies and options for strengthening the Bank's risk bearing capacity.

1.2 The major challenge facing the Bank is the competing demands on the Bank's net income, including: 1) responding to the increasing need to strengthen reserves and 2) meeting and expanding commitments made by the Bank for important development initiatives.

1.3 Although the Bank is not a profit **maximizing** institution, adequate income is needed to sustain the business growth, cover the Bank's balance sheet risks, repay borrowings, cover administrative expenses and make transfers to development initiatives. The quicker the Bank's balance sheet expands the more dependent it will become on its loan income for maintaining its strong financial position, especially in meeting needs during times of financial stress and capital constraints. Equity, through paid in capital, though important, takes years to materialize and is not intended to address exogenous financial shocks.

1.4 Also, similar to all other MDBs, the key mechanism available to the Bank to generate net income in response to rapidly changing market conditions is adjustment of loan charges. However, borrowers understandably dislike loan charge volatility; the more constant the loan charges the better. Consequently, loan charge adjustments, their timing and amount, are a continued source of discussions between member countries and Management. It requires consensus building taking into account the Bank's long term financial prospects **and equally the need to provide attractive lending terms to RMC borrowers.**

1.5 Recently, the financial crisis and global economic down-turn brought another dimension to the issue. The Bank played its counter cyclical role which has contributed to stretching its balance sheet capacity at a rapid pace. Consequently, an increase in loan charges was considered as a possible option to release the pressure on the Bank's prudential limits and build up future financial capacity. In 2009, the Board approved a suspension of the 20 basis points waiver on the contractual lending spread and the temporary suspension of fixed spread loans and subsequently the introduction of a single product (the Enhanced Variable Spread Loans). At the time of these revisions of loan charges, it was also agreed that the Board would periodically revisit loan pricing decisions.

1.6 Furthermore, during the Board retreat held on 18-19 November 2009<sup>3</sup>, there was a consensus for an increase in loan charges if necessary, provided the Bank can demonstrate that current charges were operationally unsustainable.

1.7 Management therefore, undertook a comprehensive review of the adequacy of its sovereign<sup>4</sup> operations' loan pricing [with the aim of making it more responsive to sustain cost recovery and to strengthen the Bank's future financial position without compromising competitiveness, transparency and predictability](#). Therefore, the key questions the document [attempts](#) to address are:

- Is the Bank's pricing fully aligned with the cost pass through principle?
- Is the current pricing reflective of its operating cost? and
- In the long run, can the Bank afford to maintain the current pricing structure to sustain its business growth?

1.8 This document is organized into 6 sections. Following this introduction, section 2 provides an overview of the Bank's pricing structure and various changes while section 3 reviews recent market developments and their impact on MDBs loan pricing. Section 4 presents the key core guiding principles underpinning the Bank's loan pricing. Section 5 assesses the adequacy of the Bank's current pricing both in terms of framework and charges and proposes adjustments in line with key core principles. Section 6 provides the conclusions and recommendations. A number of Annexes are provided as background reference materials.

## II. THE BANK'S LOAN PRODUCTS AND PRICING STRUCTURE

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2.1 In order to respond to the key issue of pricing: "Do the Bank's loan charges adequately cover its funding and lending operation costs?", it is important to briefly review the Bank's loan pricing structure. Annex 1 presents the various cost components of the Bank's loan products.

### The Bank's Loan Pricing Structure

2.2 Like all multilateral development finance institutions, the Bank's loan pricing structure is closely linked to its [role](#) as a financing cooperative. It generally consists of the following components:

- **Reference or base rate** corresponding broadly to a cost of funds. This has evolved over time from an average cost of a pool of borrowings to the current Libor based loans.
- **A spread** which integrates one or a combination of various factors: (i) a funding margin, (ii) contractual lending spread, (iii) a credit risk premium; and (iv) a market risk premium.

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<sup>3</sup> ADB/BD/WP/2009/235

<sup>4</sup> The term "sovereign" is used broadly to refer lending directly to sovereign governments as well as to operations guaranteed by the sovereign

- **Fees** comprising one or more of the following: front end fee, commitment fee and other fees (statutory commission<sup>5</sup>, late service fee, etc...)

2.3 **Funding margin** - Depending on market conditions the Bank would raise funds at a cost above or below LIBOR (i.e. sub-LIBOR funding cost margin). The actual funding margin is usually passed-through to the borrower in the form of a rebate or surcharge.

2.4 **The contractual lending spread** is meant to achieve essentially two main objectives: (i) cover administrative expenses; and (ii) meet net income objectives (build-up a reserve cushion against potential impairment of the portfolio). A uniform spread is applied which does not factor credit risk differences between RMCs borrowers. Historically, spreads applied to the Bank's sovereign guaranteed loans have ranged between 20 bps to 50bps, and are currently at 40 bps.

2.5 **Credit risk premium** - In the case of sovereign loans, given the cooperative nature of the Bank and its preferred creditor status, no credit risk premium is applied to sovereign and sovereign guaranteed loans.

2.6 Under special circumstances and stress market conditions, **market risk premium** could be charged to cover liquidity risks associated with some specific structured loan products.

2.7 *In this pricing framework, the key issue to address is: "should the spread ensure partial or full coverage of all administrative expenses (both operational and non-operational); and should it cover also provisions"?*

## **Loan Product and Pricing Changes**

2.8 As indicated in Annex 1, since the start of its lending operations in 1967, the Bank's lending products have evolved through three broad categories: (i) fixed rate loans which were the Bank's first lending instruments; (ii) Pool-based variable rate loans introduced in 1990 in order to address the weaknesses of the fixed rate loan products; and (iii) market based (LIBOR based) loan instruments introduced in 1997 to provide much greater flexibility to borrowers and better risk management features for the Bank. Annex 2 provides further details of the loan products through to 2009.

2.9 In 2005, and driven largely by competitiveness pressures and the need for simplicity, the Bank suspended Variable Spread Loans by eliminating the funding margin. It also eliminated the market risk premium and commitment fees and reduced the lending spread to 40 bps. In response to the impacts of the global financial crisis, in January 2009 the Bank revised the financial terms and conditions offered to its clients:

- Maintain the lending margin at 40 basis points;
- Temporary suspension of the interest rate waiver of 20 basis points introduced in 2008;
- Maintain the zero front end and commitment fee decided in 2005;
- Temporary suspension of Fixed Spread Loan<sup>6</sup> products for new commitments given the uncertainty of the duration and the magnitude of the impact of the crisis on the Bank's funding conditions; and

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<sup>5</sup> This commission is no longer applicable to the Bank's loans

- Re-introduction of a Variable Spread loan based on the Bank's cost of funds relative to Libor.

2.10 In December 2009 the Board decided to maintain the suspension of the Fixed Spread Loan as well as the 20 bps waiver and to offer one single product for the Bank's sovereign lending operations: the Enhanced Variable Spread Loans made up of a floating base rate including a [free option](#) for [fixing](#) the Libor rate.

2.11 While these changes achieved their intended objectives at the time, financial considerations such as net income allocation, capital adequacy requirements and the current discussions regarding a general capital increased (GCI), require that the Bank revisits its loan pricing.

2.12 Mathematically, the Bank's current loan pricing can be expressed as follows:

$$\text{Loan price} = (\text{i}) \text{ Base rate} + (\text{ii}) \text{ funding margin} + (\text{iii}) 40 \text{ basis points}$$

### **Current product structure of the Bank's lending portfolio and funding base**

2.13 The Bank funds its lending operations on the basis of a portfolio approach rather than on a transaction by transaction basis which is impractical except in the case of very small portfolios.

2.14 The evolution of the Bank's lending instruments as described resulted in a diverse outstanding loan portfolio consisting of a mix of instruments of differing risk characteristics and funding mechanisms. In addition, the effectiveness of the cost pass through mechanism may not remain optimal over time due to changes in the loan balances (new loans and disbursements, repayments and pre-payments) and the underlying funding (maturing and new borrowings).

2.15 [Table 01 below presents the breakdown of the outstanding loan balances as at December 31st 2009 by type of instruments. Currently only about 42% of the Bank's outstanding portfolio is on a full cost pass through basis or 54% of the total disbursed and undisbursed balances.](#) These loans correspond to the single currency variable rate loans, variable spread loans pending fixing and variable spread loans on floating base rate basis.

2.16 [Fixed spread loans for which the refinancing risk is more significant currently represents 28% of the outstanding portfolio.](#) This is because the Bank's funding margin (reflecting its own borrowing or credit spread in the markets) is not transferred to the borrower with this instrument. These loans include market based loans with a fixed spread approved between 2005 and 2008. [Taking into account the undisbursed balances, this percentage will increase marginally to 29%, still representing a sizeable exposure to refinancing risk for the Bank.](#)

2.17 A key assumption underpinning many of the Bank's pricing considerations (as well as those of most other MDBs) was that MDBs would always be able to achieve sub-LIBOR funding levels. However the recent financial crisis has highlighted that this may not always be true in times of systemic stress. Should borrowing costs increase and

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<sup>6</sup> The fixed spread loan refers to a loan which is priced as the base rate + fixed lending spread. No funding margin is applied.

remain at levels observed during the first semester of 2009, the Bank's net income margin will be negatively impacted.

2.18 *It is therefore imperative for the Bank to ensure that going forward all lending instruments reflect an effective full cost pass through. At the same time the Bank may consider charging for liquidity and refinancing risks.*

**Table 01: Public Sector Portfolio Structure by Product as at 31-Dec-2009  
(UA Million)**

	Funding Margin Applicable	Outstanding Balance	%	Undisbursed Balance <sup>1</sup>	%	Cost Pass Through
<b>1. Multi-Currency Fixed Rate Loans</b>	No	<b>818</b>	<b>13%</b>	<b>2</b>	<b>0.0%</b>	No
<b>2. Single Currency Variable Rate Loans (VLR)</b>	No	<b>542</b>	<b>9%</b>	<b>10</b>	<b>0.2%</b>	Yes
<b>3. Market Based (Libor)</b>		<b>4 805</b>	<b>78%</b>	<b>4 699</b>	<b>99.8%</b>	
-Variable spread loans ( 50, 40 bps)		3 057	50%	3 264	69%	
a) Fixed base rate						
- Already fixed	No	991	16%	-	0%	No
- Pending fixing <sup>2</sup>	Yes	1 151	19%	3 148	67%	Yes
b) Floating base rate	Yes	915	15%	116	2%	Yes
- Fixed Spread loans ( 40, 20 bps)		1 748	28%	1 436	30%	
a) Fixed base rate						
- Already fixed	No	433	7%	-	0%	No
- Pending fixing <sup>2</sup>	No	859	14%	1 184	25%	No
b) Floating base rate		456	7%	252	5%	No
<b>TOTAL</b>		<b>6 165</b>	<b>100%</b>	<b>4 711</b>	<b>100%</b>	

### III. RECENT MARKET DEVELOPMENTS AND THEIR IMPACT ON MDBs LOAN PRICING

3.1 MDBs by their very structure are closed financial systems, relying on equity (paid-in capital) and guarantees (callable capital) provided by shareholders and net income generated through loan charges. As a result of the financial crisis there is a drive towards enhancing the net income generation capacity stemming primarily from increased risk bearing requirements (for capital adequacy and transfers to soft windows and development initiatives).

3.2 In periods of financial stress, a capital increase cannot serve effectively as a first response, given the time required to propose, agree to and provide resources. Equally, earning a positive return on conservatively managed liquid investments is not considered a primary development bank objective in most MDBs; as such, even in the best of circumstances, net returns on investments are not expected to be significant.

3.3 One of the most important mechanisms in enhancing net income generation capacity is the level of loan charges. *Therefore, most MDBs regularly review their loan pricing for sovereign loans.*

#### **Recent changes by sister MDBs and rationale**

3.4 Most MDBs have revised their pricing terms over the past few months and [continue to review their loan pricing policy generally](#). In August 2009, as part of the annual loan pricing review and net income allocation exercise, the IBRD raised their contractual lending spread on new commitments from 30 basis points to 50 basis points, to maintain financial sustainability in a context of reduced capital.

3.5 Similarly, in June 2009, the Board of Directors of the Inter-American Development Bank (IADB) approved an increase in loan charges applicable for a one year period from 30 basis points to 95 basis points, in order to leverage their balance sheet to address the needs of their borrowing countries and to maintain a strong financial position vis à vis investors and rating agencies. It is worth noting that the loan pricing structure of IADB adopted many years ago is such that the lending spread is not fixed but is determined by the bank from time to time based on its financial position. The effect is that changes to the loan charges are applicable to the entire pool of loans outstanding and can therefore have a significant and immediate impact on income.

3.6 The Asian Development Bank (AsDB) has approved a revision of loan charges on new Libor based loans and local currency loans to sovereign borrowers negotiated on or after 1 July 2010. Under the new loan pricing structure, the effective contractual spread will be gradually adjusted to 40 bps from the current charge of 20 bps per annum (30 bps for loans negotiated from 1 July 2010 to 30 June 2011, and 40 bps on or after, 1 July 2011).

### **Comparative MDB loan pricing levels**

3.7 Lending terms for sovereign loans vary across MDBs and depend on the type of loan offered. Two types of loans are available to sovereign and sovereign guaranteed borrowers, the Variable Spread Loan (VSL) based on the cost of borrowing relative to Libor plus a lending spread and the Fixed Spread Loan (FSL) priced with a fixed spread over the Libor.

3.8 As is evident in Table 02, the IBRD is the sole MDB that offers both loan products; other institutions offer solely VSL products. The VSL pricing methodology is similar for all MDBs, consisting of a base rate plus funding margin plus contractual lending spread. IBRD has the lowest (best) funding margin for USD, followed by AsDB, IADB and ADB. Indeed, as a result of the recent financial crisis during which funding spreads generally increased, some MDBs have not recorded significant changes in their funding margins primarily for the following reasons (i) with a larger outstanding stock of borrowings, new borrowings contracted at less competitive Libor levels, have had a very marginal impact on the funding margins; (ii) Other MDBs borrowing strategy targeted the very short end of the curve (including the ECP market) where sub-Libor funding levels could still be achieved.

3.9 The current pricing methodology of FSLs provided by IBRD is maturity based and compensates for two main risks (i) the expected future funding cost and (ii) the volatility of future funding cost (Risk Premium). The current risk premium is 10 bps for average maturity lower than 14 years and 15 bps for longer than 14 years.

3.10 Additional loan charges like Front End Fee or Commitment Fee are applied by most institutions.

**Table 02: Comparators benchmarking of lending terms to sovereign clients**

(As at March 2010; in basis points)

Loan Type	ADB	IBRD				IADB	AsDB
	Variable Spread (VSL)	Flexible Loan			Single Currency Facility	Libor Based	
		Variable Spread (VSL)	Fixed Spread (FSL) <sup>7</sup>				
1- Maximum Maturity (Years)	20	30	Less than 10 years	Between 10 and 14 years	More than 14 years	25	NA <sup>8</sup>
2- Maximum Grace	5	8	8	8	8	5	NA
3- Base Interest rate	Libor(L)	Libor(L)	Libor (L)			Libor(L)	Libor(L)
4- Interest Charges:							
- Contractual	40	50	50	50	50	95	20
- Sub Libor Benefit	4	-26	0	20	40	3	-28
- Market risk	-	-	10	10	15	-	-
<b>Net Spread over the</b>	<b>44</b>	<b>24</b>	<b>60</b>	<b>80</b>	<b>105</b>	<b>98</b>	<b>-8</b>
5- Charges:							
- Commitment	-	-	-	-	-	25	-
<b>Spread Equivalent of Commitment fee(c)<sup>9</sup></b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>9</b>	<b>-</b>
6- Front-end Fee:							
- Contractual front	-	25	25	25	25	-	15
<b>Spread Equivalent of Front-end fee (d)<sup>10</sup></b>	<b>-</b>	<b>5</b>	<b>5</b>	<b>5</b>	<b>5</b>	<b>-</b>	<b>5</b>
<b>Total Indicative Lending Rate (a+b+c+d)</b>	<b>L +44</b>	<b>L +29</b>	<b>L +65</b>	<b>L +85</b>	<b>L +110</b>	<b>L +107</b>	<b>L -3</b>

3.11 Further changes are currently being envisaged by some MDBs in their pricing terms.

### Lessons learnt from pricing changes

3.12 As a result of the financial crisis, most MDBs have embarked on reviewing their pricing with two objectives: to ensure effective cost recovery and to generate more net income in order to sustain increased risk bearing requirements in a context of capital constraints. They have also explored longer term options for a reasonable and flexible pricing approach directly or indirectly linked to their capital adequacy framework.

3.13 The loan spread, is the key financial variable under the direct control of the MDBs. *However, unlike some other MDBs, the Bank has limited flexibility to adjust its loan spread to meet specific financial objectives or address financial stress.* Some MDBs have the ability to apply an increase in their contractual spread to the whole loan portfolio, such mechanism allowing them to address the risk capital constraint more easily, a vital requirement giving them much needed flexibility.

<sup>7</sup> For IBRD FSL, the maturity indicated is the maximum average maturity

<sup>8</sup> For the AsDB, maturity and grace period are project specific

<sup>9 & 10</sup> Spread-equivalent computations for commitment charge and front-end fee use average project disbursement profile of 8 years. Repayment terms used are as follows: Final Maturity: 30 Years; Grace Period: 5 Years; Level repayment of principal. Disbursement profiles and payment terms vary across MDB's and hence spread-equivalent charges would vary based on the disbursement profile and payment terms used

3.14 In terms of pricing structure only the [African Development Bank](#) does not apply a front end or commitment fee. This has further limited the Bank's income generation capacity over the past few years.

#### **IV. GUIDING PRINCIPLES FOR THE BANK'S LOAN PRICING FRAMEWORK**

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##### **Pricing framework – Anchors to the Bank's charter**

4.1 It is worth recalling that the Bank's pricing is anchored in its charter. The principles for the pricing of the Bank's loans and guarantees are indeed embodied in Articles 17 (f and k) and 18 of the Agreement Establishing the African Development Bank which stipulate that: (i) interest rates and charges should be reasonable; (ii) the Bank shall receive suitable compensation for risk; (iii) terms and conditions shall take due account of terms and conditions on which the corresponding funds were obtained by the Bank (i.e. a cost of funds-plus basis); and (iv) the Bank should apply sound banking principles.

4.2 Over time, the application of these principles have been adapted to reflect the specific circumstances of the Bank's evolving operating environment and portfolio as well as the practices of other sister MDBs. Hence, the Bank regularly reviews its loan pricing structure in order to take into account the requirements of borrowers, the need to enhance its financial intermediation capacity, the conditions in the financial markets and also to ensure the sustainability of its income.

##### **Guiding principles for Sustainable Pricing Level**

4.3 The continued success of the Bank to intermediate competitive borrowing terms for its RMCs is largely dependent on its ability to maintain a sound financial standing in the financial markets. To maintain such status, the Bank must strive at all times to generate sufficient levels of net income to:

- Build much needed reserve capacity to sustain loan growth and absorb potential portfolio losses as a normal cost of doing business;
- Strengthen its equity base and income generation capacity; and
- Support transfers of net income to mandatory recurrent undertakings, ADF and other development related initiatives.

4.4 In this respect, active income management and an adequate loan pricing framework are key elements in securing the financial integrity of the Bank needed to maintain the AAA rating and increase the Bank's relevance to MICs and LICs through private sector operations.

4.5 To ensure that these objectives are met, a balanced loan pricing strategy is paramount. For a multilateral development finance institution, not profit [maximizing](#), with a continental mandate and operating in an increasingly volatile environment such as the Bank, the strategy is anchored on five core guiding principles:

- First, loan charges should be reflective of the true cost of funding;

- Second, they should be adequate to cover structural costs associated with the Bank's operations (i.e. lending related expenses), bearing in mind considerations of efficiency in the management of expenses;
- Third, they must have embedded flexibility for absorbing average expected losses over the lifetime of the loan and recover capital costs [with due regard to borrowers financial constraints](#);
- The fourth important feature is competitiveness with comparable institutions/or the market and ability to support portfolio growth; and
- The fifth component is predictability and transparency.

***Effective recovery of funding and lending costs - "cost recovery and cost pass through principles"***

**Funding cost pass through**

4.6 To the extent possible, lending products offered to clients should be based on a "full cost pass through" of borrowing costs in order to ensure that refinancing risks are limited and will not jeopardize the Bank's financial integrity. Under the currently available loan product, the Enhanced Variable Spread Loan (EVSL), the Bank passes the full funding cost / benefit to the borrowers.

**Recovery of operating cost of making loans**

4.7 As a sound Management principle, the structural cost of operations (i.e. costs of preparation, evaluation, implementing and monitoring of loans) should be covered through the pricing of services. Therefore in setting its loan pricing the Bank should ensure adequate coverage of administrative expenses associated with lending operations through the lending spread. However, this also raises the question as to whether loan charges should cover all administrative expenses or only a subset directly related to the lending operations. In this respect, it is worth recalling that the Bank's administrative expenses are divided in two categories:

- **operational expenses** that include two groups of expenses; (i) direct lending costs i.e. expenses directly linked to lending operations (direct financing of project cycle activities having one-to- one relationship with lending); non-lending services (Analytical works, ESW&CSP and activities to maintain relationships with borrowing countries); and costs associated with cross cutting issues or provision of global/regional public goods; and (ii) lending support costs that are associated with legal, treasury, disbursements, billing, procurement and post evaluation etc;
- **non-operational expenses** that are the costs associated with institutional programs not directly linked to lending operations.

4.8 The challenges of recovery of the full cost of making loans rely on the practicality of unbundling the various services provided to borrowers, quantifying costs and redistributing the charges appropriately. To address this challenge in line with cost allocation principles in the absence of a [simple and flexible](#) Time Recording System

(TRS)<sup>11</sup>, the loan pricing should at a minimum cover the operational expenses. However, recently concerns have been raised as to whether the pricing should not cover the full administrative cost of making loans whether direct, direct support or indirectly related to lending operations.

4.9 In line with the above concern, although it is true that to the extent possible, lending products offered to clients should be based on a “full cost pass through” of all costs directly associated to making loans, determining such an administrative cost coverage could only be made after the implementation of the current UA budgeting and its associated TRS. *In the absence of such a system, this analysis focuses on operational expenses that are more easily identifiable.*

### ***Embedded flexibility and recovery of capital charges***

4.10 To maintain the Bank’s financial integrity, loan pricing should also serve to build a cushion against potential shareholders’ capital impairment and to sustain risk bearing capacity due to unexpected increases in loan approvals/disbursements or to cover portfolio impairments or payment interruptions linked to loans in arrears. *While a capital increase will improve the Bank’s financial strength, it is not necessarily suitable for situations requiring immediate responses.*

4.11 Therefore, in order to respond quickly to negative events such as the default of major borrower(s), the Bank should be in a position to quickly reinforce its reserves through the generation of adequate net income and to provide coverage for expected losses. Adequate loan income will also enable the Bank to respect, to the extent possible, past and new undertakings for net income allocation to development initiatives. Furthermore, the increased volatility in the external environment requires enhancing the flexibility in loan charges to protect the financial capacity of the Bank.

4.12 These objectives can only be met if an increase in the lending spread results in a meaningful and timely increase in loan income that strengthens equity [with due regard to borrowers financial constraints](#). The stress-tests below illustrate the potential risk exposures that the current loan pricing policy might generate in the event of non-accrual events. The tests are performed on a simulation of what-if-scenarios on the last five years history of the Bank’s Balance sheet.

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<sup>11</sup> During the implementation of the UA budgeting system, the Bank also plans to implement a reliable TRS and analytical cost accounting system. These new systems are expected to be fully tested by the year 2012 and should permit the full review of the cost sharing methodology between the Bank Group institutions as well as the establishment of a stronger linkage between direct expenses related to lending activities.

**Table 03 - Reduction in Income transfers due to Portfolio Impairment (non-accrual shock)**

<b>Default Event</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
Impairment of 24% of the loan portfolio	-34%	-34%	-49%	-65%	-35%	-69% <sup>1/2/</sup>
Impairment of 43% of the portfolio (correlated default events of several borrowers)	-95%	-82%	-100% <sup>1/</sup>	-100% <sup>1/</sup>	-60%	-100% <sup>1/2/</sup>

<sup>1/</sup> At this point no net income is passed to Reserves, thus limiting future lending growth

<sup>2/</sup>Assumes Loan charges weighted average for year 2009 is the same as for year 2008.

### ***Competitiveness and Predictability to borrowers***

4.13 With respect to the guiding principles that are non-cost based, to the extent possible, the lending rate should be predictable and competitive relative to the lending rates of other Development Finance Institutions active in Africa and to funding alternatives in the capital markets. **Indeed, the Bank must be relevant for borrowers and remain competitive in the market.** However, these objectives may at times be inconsistent with the objective of maintaining the financial integrity of the Bank, in which case priority should be given to the Bank's financial integrity.

4.14 It is important to note that some of these above guiding principles are embedded in those initially established in 1986<sup>12</sup>, and still remain largely valid despite the significant changes that occurred in the Bank's operating environment. The premise of the balanced pricing guidelines for sovereign operations are equal risk (non risk based pricing), cost pass through and sustainable income generation capacity to maintain the Bank's financial integrity, adequate recovery of structural cost of operations, competitiveness and predictability.

## **V. FLEXIBLE AND FAIR ADJUSTMENT TO THE BANK'S LOAN PRICING FRAMEWORK**

### **Adequacy of the Bank's Loan Pricing**

5.1 There are key issues to address in order to ascertain that the current pricing structure is adequate and aligned with the requirements of a sustainable level of pricing: (i) is the Bank's pricing fully aligned with the cost pass through principle; (ii) is the current pricing reflective of its operating cost; and (iii) in the long run can the Bank afford to maintain the current pricing structure to sustain its business growth?

### ***Funding cost past through***

5.2 In the past, the Bank has not effectively achieved a full "cost pass through" mechanism between its cost of funds and the loan charges to its borrowers, mainly due to the creation of several new lending instruments in response to competitiveness concerns. However, since the reintroduction of Variable Spread Loan and the suspension of Fixed Spreads Loans in 2009, the Bank's available lending products are aligned with this first guiding principle. Should the Bank consider reintroducing Fixed Spreads Loans, market risk and tenor risk premiums would have to be re-considered as a cost of providing such loans.

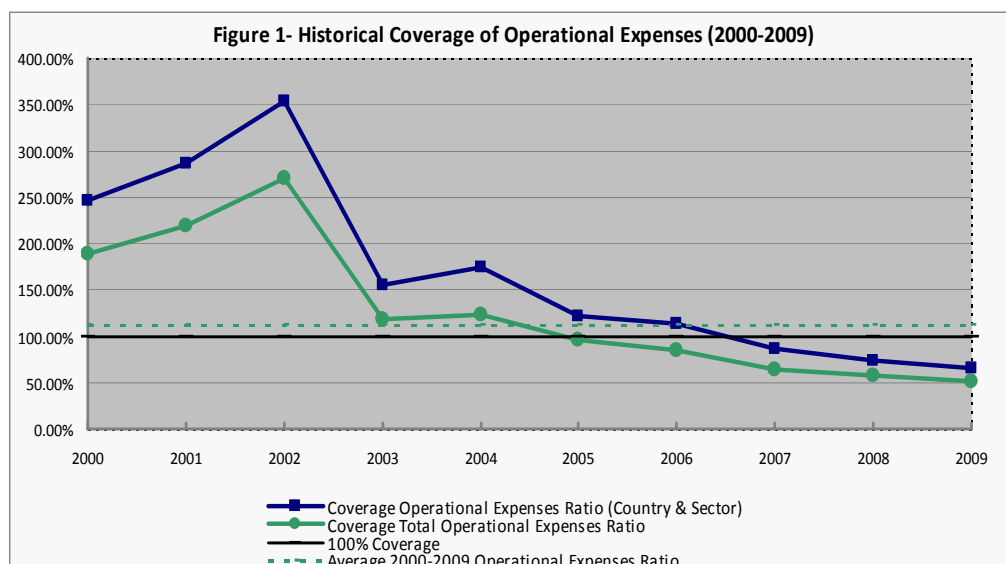
<sup>12</sup> See Board Document ADB/BD/WP/86/156 entitled "Search for a suitable Lending rate Methodology"

## Recovery of operational costs<sup>13</sup>

5.3 Figure 1 which shows the evolution of the operational administrative expenses cover ratio from 2000 to 2009 indicates that while the Bank used to fully cover total operational expenses,

the ratio has fallen below 1 and has also been on a declining trend for the last five years.

Since 2007, the Bank was not



even able to fully cover sector and country department expenses. This is due to a combination of factors of which decreasing fees and increasing expenses form a large part. Simulation of coverage requirements summarized in Annex 3 indicates that an additional margin of 43 bps would have been required to cover operational expenses in 2009. Also, if the Bank has to cover at a minimum the costs incurred by only sector and country departments, 24 bps would be required. Furthermore, the analysis of the Bank's income generation since 2000 shows a decrease in loan income by 47% mainly due to a sharp decrease in fees (97%). It is important to note that fee income previously formed a sizable portion of the Bank's income and are currently no longer applicable. Consequently, the Bank is no longer in a position to generate a cushion to absorb average expected losses associated with its loans. Annex 3 provides more detailed analysis on such an assessment.

## Flexibility and Competitiveness

5.4 In the wake of the financial crisis, certain rating agencies have indicated that the ability to quickly adjust the Bank's pricing in response to stress events would constitute favorable rating factors. While the Bank's current structure presents the advantage of simplicity, it offers little room for adjusting loan revenues by adapting its loan charges to specific market conditions and new developments in the loan portfolio structure.

<sup>13</sup> Operating expenses indicated in this report use the same terminology as the Budget and Cost sharing formula of the Bank. Total Expenses are composed of operational expenses and non-operational expenses. Operational expenses are made of the expenses of three groups of cost centers: sector, country and direct support cost expenses. For the purpose of this analysis private sector cost centers related expenses are subtracted from the operational expenses.

5.5 In the past competitiveness was a major argument against loan pricing structure changes. While competitiveness is an important factor to monitor, the approval volume of new loans was not significantly impacted by the various changes in the Bank's lending spread from 2005 to 2009 as indicated in Table 04. Furthermore, in addition to competitiveness, the primary objective of the review is to protect the Bank's financial integrity and enhance in its intermediation capacity vis-à-vis the borrowers.

**Table 04: ADB loan Approvals by Sector, 1964 - 30-Sept-2009**

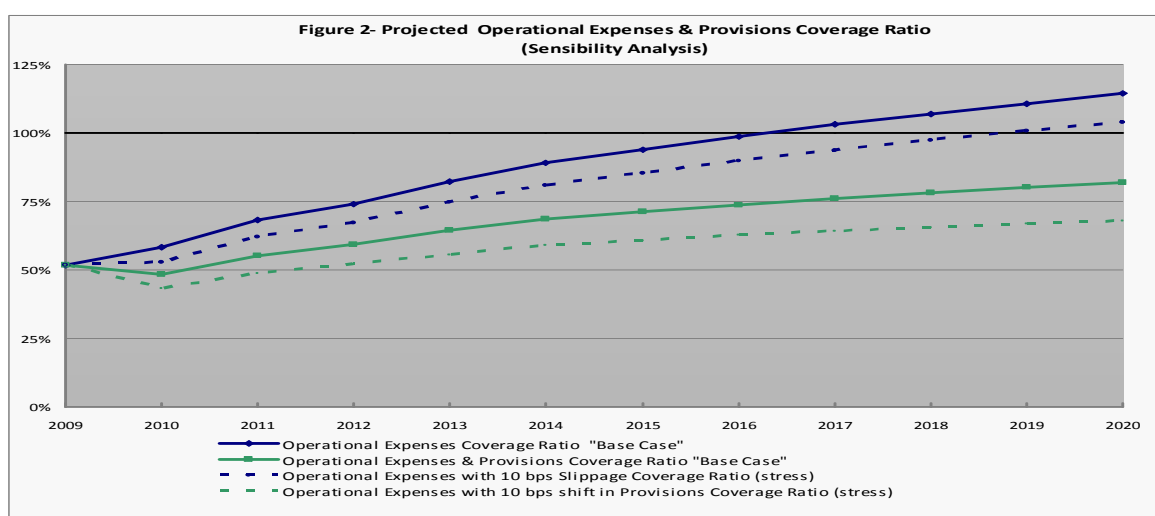
(UA million unless otherwise specified)

Approvals	1 Jan 64	1Jan 90	1 Jan 98	4May05	2Jun08	21Jan09
	31Dec89	31Dec97	4May05	2-Jun-08	21Jan09	30Sep09
	Fixed 50bps	VRL 50bps	VSL 50bps	FSL		VSL
				40bps	20bps	40bps
Public Sector approval level	7,638	7,883	4,677	2,071	54	1,596
Private Sector approval level		89	1,077	1,730	86	650
Total approval	7,638	7,972	5,754	3,801	140	2,246
Period duration in years	26.0	8.0	7.3	3.1	0.6	0.7
Average volume of annual approval (Public sector)	294	996	784	1,233	220	3,254
Number of borrowing countries (Public sector)	26	22	20	16	3	7
Number of loan transactions (Public sector)	540	174	146	63	3	8

### Long Term Sustainability of the Bank's pricing level

5.6 A periodic review and adjustment whenever necessary is paramount to ensure the shared objective of long term sustainability of pricing. The baseline financial projections of the Bank illustrated by figure 2 shows that:

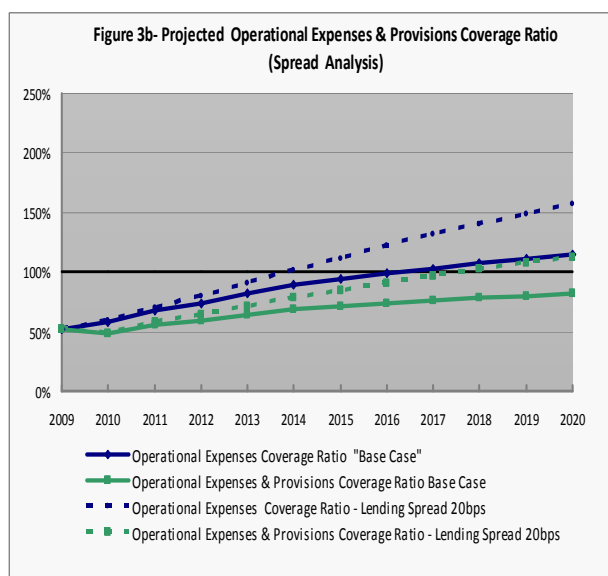
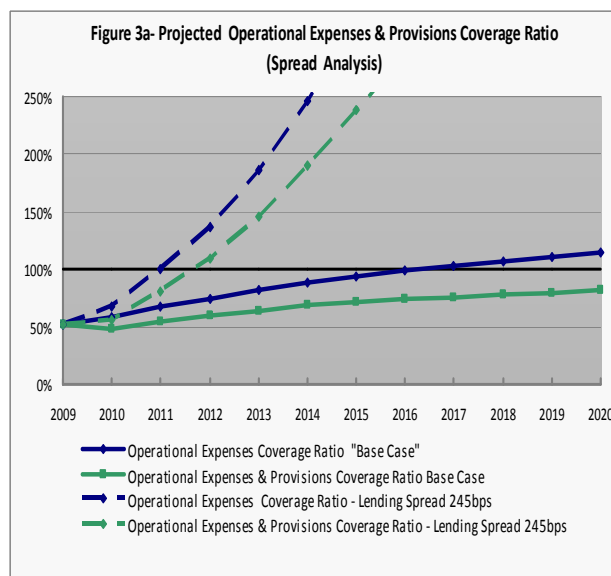
- Operational expenses will only be covered by loan income from 2016, despite the assumptions of significant growth of outstanding loans<sup>14</sup> and stable administrative expenses.
- If loan loss provisions are also considered, the Bank will not recover its operational expenses and provisions during the period 2010-2020.



5.7 Moreover, if the Bank continues to maintain its loan pricing structure and apply a lending spread of 40 basis points irrespective of financial conditions it will not be in position to quickly generate enough income to face a shift in the trend of expenses such as a significant increase in cost resulting from: (i) an eventual change in cost sharing formula and the share allocated to ADB, or (ii) an increase in loan loss provisions as a result of potential deterioration of its asset quality. This is corroborated by the result of the sensitivity analysis illustrated by figure 2.

5.8 If the Bank were to keep the same pricing going forward, a 200% Capital Increase will only be sufficient to maintain its risk capital utilization below 99% until 2016 (Annex 4), raising concerns about the long term sustainability of the Bank's pricing. *It is also important to underscore that the later the increase in pricing the higher the additional margin required to generating sufficient additional income to maintain the Bank's financial strength.*

5.9 Therefore, the sustainability of the Bank's pricing level has to be considered over different time horizons (short, medium and long term) **factoring the need to lessen the burden on borrowers and ensure competitiveness**. Indeed, if the Bank were to adjust its lending spread to ensure full coverage of operating expenses in the short term, the increase required would be very costly for borrowers at **+245 bps<sup>15</sup> for 100% coverage of operational expenses in 2011 or +100 bps for 2012**. Thereafter, the coverage would be high as illustrated by figure 3a. **Targeting a full coverage of operational expenses after the end of the MTS period (around 2014) and a reasonable coverage of provisions from 2017**, the spread would need to be adjusted upward by around 20 bps as shown in figure 3b. These conclusions are valid under normal operating conditions, should the portfolio quality deteriorate or the administrative expenses and ADB share in these expenses increase after the MTS period, the coverage ratios will be much lower. Annex 3 provides the result of different scenarios.



<sup>14</sup> Large balances of outstanding loans provide an important loan income basis.

5.10 In the light of the above assessment, several measures have been considered by Management to address the issues of adequacy of charges and pricing structure. The measures proposed could be classified into two broad categories: (i) measures to address the principle of loan pricing flexibility; and, (ii) specific pricing adjustments to address the current inadequacy of loan charges without jeopardizing competitiveness.

## **MEASURES TO ADDRESS THE PRINCIPLE OF LOAN PRICING FLEXIBILITY**

### **Measure 1 – Periodic review of the adequacy of the lending spread for new loans**

5.11 The lending spread for new loans should be reviewed within the framework of the Medium Term Financial Outlook of the Bank and subject to Board approval. **Any proposed changes in lending spread would only apply to those loans approved after the annual adjustment thereby avoiding borrower concerns of retroactive applicability.** This would provide the Bank with a tool to effectively manage loan income while protecting its intermediation capacity for the interest of the borrowers.

5.12 The review shall be based on a trigger mechanism. At this stage, one trigger mechanism is proposed for the review of loan charges: the coverage of operating costs. This trigger should be set at 100% minimum coverage of the operational expenses. However, in line with the guiding principles, loan charges should cover operating as well as capital cost and a trigger mechanism based on capital adequacy would have to be considered in the future. This mechanism could be based on target threshold level RCUR or equity to loan ratio.

### **Measure 2 - Revision of loan pricing for exceptional stress events**

5.13 Lessons learned from the financial crisis, call for ensuring that stress events will not create an undue burden on Bank's borrowers and its limited resources. Coupled to this factor is the recent consideration in the rating of MDBs of their flexibility to adjust their pricing framework to unforeseen changes in their operating environment. Furthermore, the rationale for the Bank to factor stress events in order to maintain its long term financial sustainability is that a GCI is normally approved for longer term period, typically an average of ten years. If at a certain point in that cycle net income decreases significantly and becomes negative because of income losses (significant impairments), pushing thereby RCUR to reach 100% (after passing the losses to reserves) the Bank shall consider having a flexible and efficient tool, other than a capital increase, to quickly respond to such crisis situations; requiring the strengthening of the Bank's financial position without a drastic reduction in lending operations.

5.14 Therefore, as part of the range of measures that Management and the Board may take to protect the Bank's balance sheet and financial integrity and to maintain its credit AAA rating, in response to **exceptional unforeseen stress events**, an upward adjustment of the price of loans signed after the date of the adoption of this policy could

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<sup>15</sup> Very sensitive to growth in outstanding and level of expenses. The increase compared to earlier projections is attributable to a slower expected growth of outstanding balances and the projected evolution of expenses.

be considered for a **limited time**. The Board of Directors shall approve the qualification of an event as exceptional, the related level of pricing adjustment and application period.

5.15 More importantly, such approach would reflect the strongest affirmation of exceptionally strong shareholder commitment and support enshrined in the cooperative nature of the Bank.

## **SPECIFIC MEASURES TO ADDRESS THE ADEQUACY OF LOAN CHARGE COVERAGE**

### **Measure 3 - Upward adjustment of the lending spread for new loans**

5.16 As demonstrated in the above assessment, a spread increase of 245 bps would be required to cover operational expenses in 2011 or 100 bps in 2012. However, given the Bank's mandate to offer reasonable lending terms to borrowers, that are doable and absorbable, such level would not be sustainable. Therefore, the impact of different levels of loan charges on the Bank's income and coverage ratios is assessed by simulating an increase in the lending spread of 15, 20, 30 and 40 bps respectively for all new loans approved from 2010, assuming that such increase does not impact the demand for the Bank's loans. Table 05 presents a summary of the results of the simulations for the proposed measure while Table B in Annex 3 provides more details.

**Table 05 – Coverage of Operational Expenses and Provisions - with an upward adjustment of the lending spread by 20 basis points**

Scenarios	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
<b>Base Case Scenario</b>												
Operational Expenses	52%	58%	68%	74%	82%	89%	94%	99%	103%	107%	111%	114%
Oper. Expenses & Provisions	52%	48%	55%	59%	64%	69%	71%	74%	76%	78%	80%	82%
<b>Management Proposal (20 bps increase in spread)</b>												
Operational Expenses	52%	59%	71%	79%	91%	102%	112%	122%	131%	140%	149%	157%
Oper. Expenses & Provisions	52%	49%	57%	63%	71%	78%	85%	91%	97%	102%	107%	112%
<b>Sensitivity Analysis of Management Proposal</b>												
<b>Increase in Operational Expenses 10%</b>												
Operational Expenses	52%	54%	64%	72%	82%	93%	102%	111%	119%	128%	135%	142%
Oper. Expenses & Provisions.	52%	45%	53%	59%	66%	73%	79%	85%	90%	95%	100%	104%
<b>Increase in Provision 10%</b>												
Operational Expenses	52%	59%	71%	79%	91%	102%	112%	122%	131%	140%	149%	157%
Oper. Expenses & Provisions.	52%	44%	51%	56%	61%	67%	72%	77%	82%	86%	90%	93%

5.17 As shown in Table 05, an upward adjustment of 20 basis points (from 40bps to 60bps) only ensures partial coverage of the operational expenses until 2014. During this period neither operating expenses nor provisions are covered. Full coverage of the operational expenses will be achieved after the end of the MTS period (around 2014) and the coverage of the expected level of provisions would only occur in the longer term (2017). Therefore, it is important to begin to build in the recovery of provisions as the profile of the portfolio is likely to change in the future.

5.18 Furthermore, an upward adjustment of 20 bps of the lending spread would generate an additional cumulative net income of UA 144 million over the period 2010-2020 (to be compared to a net income estimate of UA 150 million in 2010). The annual incremental impact although low will slowly strengthen the Bank’s capacity to generate internal capital resources or make prudent transfers of net income to development initiatives while protecting the reserves. Moreover, the Bank would maintain the RCUR below 99% until 2018 assuming a GCI of 200% with 6% Paid in Capital. More details of this analysis are provided in Annex 4.

5.19 It can be argued that the proposed upward adjustment in lending spread would make the Bank’s lending terms less competitive than other MDBs and the market. Table 06 shows that the Bank’s contractual spread remains in line with other MDBs<sup>16</sup>.

**Table 06: Comparison of the Bank’s contractual spread with those of other MDBS after the proposed 20 bps Adjustment**

Loan Type	ADB	IBRD				IADB	AsDB
	Variable Spread (VSL)	Flexible Loan				Single Currency Facility	Libor Based
		Variable Spread (VSL)	Fixed Spread (FSL) <sup>1</sup>				
Contractual Spread over the Base rate	60	50	50	50	50	95	20->40

5.20 With respect to comparison vis-à-vis the market, while the cost of bond market issuance for sovereigns has declined substantially since the peak of the crisis, they still remain high compared to pre-financial crisis levels and compared to the Bank’s lending margins. For example, South Africa has tapped the international capital market twice in 2009 (May and August) for 10 year funds at spreads of 370 and 215 basis points respectively. These bonds are currently (January 2010) quoted at a spread of 170 basis points over Libor. A commonly used market comparison is the Credit Default Swap rate (CDS). Table 07 shows the evolution from 2003 to 2009 of the 5 year CDS spreads for Egypt, Morocco, Tunisia and South Africa. Current spread levels are above the 60bps of the Bank and, more importantly, the Bank offers longer maturities for its products (20 year final maturity).

<sup>16</sup> Lending spread excluding funding margin and market risk.

**Table 07: 5 – year CDS of African Countries in bps**

Country	2003	2004	Pre-crisis June-2007	Crisis March-2009	Post-Crisis October-2009	Post-Crisis January 22, 2010
Egypt	348	166	75	650	209	254
Morocco	281	156	45	335	105	110
Tunisia	195	114	30	338	109	107
South Africa	149	105	25	524	124	149

**Measure 4 - Introduction of a Graduated Commitment fee for fast disbursing Policy Based Loans**

5.21 Given the challenge of managing the Bank’s risk bearing capacity even after GCI-VI, Management also proposes to introduce a graduated commitment fee on fast disbursing policy based loans. The purpose of the graduated fee is to discourage borrowers, without imposing an undue penalty, from delaying disbursements on loans possibly contracted for precautionary purposes only, thereby using up risk capital that could be available for other lending<sup>17</sup>. The fee would commence at 25 bps from the scheduled disbursement date of each tranche and increase by 25 bps every six months thereafter, to a maximum of 75 bps<sup>18</sup>, on any undrawn portion of each tranche.

**In summary, these measures would translate mathematically into the loan pricing structure presented in Table 08.** The benefits of all measures proposed to address structural issues in the Bank’s pricing framework and adequacy of loan charges must inevitably be weighed against the impact it may have on the competitiveness of the Bank’s lending instruments. However, priority should be given to the Bank’s financial integrity.

**Table 08: Summary of Proposed Price Adjustments**

Loan Price	Measure	Current	Proposed
Base rate	None	Libor	Libor
Contractual Lending Spread	Measure 3	40	60
Funding Cost Margin	None	Based on market conditions	Based on market conditions
Commitment Fees	Measure 4	NA	25 to 75 bps (PBLs only)

<sup>17</sup> The average length of disbursement of Policy Based Loans in ADB’s Portfolio is 1.9 years.

<sup>18</sup> 75 bps was the fee applied before the cancellation of commitment fees. .

## VI. CONCLUSION AND RECOMMENDATIONS

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6.1 The Bank is better prepared than ever before to play a leading role in assisting RMCs to achieve their development goals. Since 1999 there has been considerable progress in enhancing the Bank's loan products and intermediation capacity. Moving forward, in order to strengthen the Bank's financial capacity while responding to the growing RMC needs, a flexible price recovery mechanism for the sovereign guaranteed lending is paramount.

6.2 In this regard, Management has reviewed the current loan pricing structure and makes the following recommendations:

### MEASURES TO ADDRESS THE PRINCIPLE OF LOAN PRICING FLEXIBILITY

- **Measure 1 - Review of the adequacy of the lending spread for new loans**

A review of the adequacy of the lending spread for new loans should be performed within the framework of the Medium Term Financial Outlook of the Bank. If the lending spread does not cover 100% of operational expenses -which will be a trigger mechanism-, Management will make a formal proposal of adjustment to the Board if deemed necessary.

- **Measure 2 - Revision of loan pricing for exceptional stress events**

As part of the range of measures that Management and the Board may take to protect the Bank's balance sheet and financial integrity and to maintain its credit AAA rating, in response to **exceptional unforeseen stress events**, an upward adjustment of the price of loans signed after the date of the adoption of this policy could be considered for a **limited time**. The Board of Directors shall approve the qualification of an event as exceptional, the related level of pricing adjustment and application period.

### SPECIFIC MEASURES TO ADDRESS THE ADEQUACY OF LOAN CHARGE COVERAGE

- **Measure 3 - Upward adjustment of the lending spread for new loans**

Given that medium term income prospects indicate that the Bank is unlikely to fully recover its operating costs and provisions, the current spread should be adjusted upwards to protect the Bank's balance sheet. Management proposes an increase in the current spread by 20 basis points in 2010, which would bring the contractual spread from 40 to 60 basis points.

Although this will only achieve partial coverage of operational expenses in the short term, **it would enable full coverage of operational expenses after the end of the MTS period (around 2014) and coverage of the expected level of provisions by 2017**. If in future years the Bank's financial condition improves a downward adjustment could be considered by the Board to ease financial burden on borrowers.

- **Measure 4 - Introduction of a Graduated Commitment fee for fast disbursing Policy Based Loans**

Management proposes to introduce a graduated commitment fee ranging from 25 bps to 75 bps on fast disbursing policy based loans made for precautionary lending that freeze risk capital if not disbursed.

## The Bank's Loan Pricing Framework

	Non-Market Based loans			Market Based Loans		
	Old Fixed Rate	Multi-currency Pool Based VLR	Single Currency VLR	Floating Rate	Fixed Rate Loan	Variable Spread Loan <sup>19</sup>
PERIOD	(1967-1990)	(1990-1997)	(1997-2009)	(1997-2009)	(1997-2009)	(2009-2010)
Reference Market Rate	Average Cost of Funds <sup>20</sup>	Average cost of Pool of Borrowings	Average cost of Pool of Borrowings	6 month reference rate in the lending currency (e.g. Libor)	Fixed amortizing swap rate vs Libor	Libor
<b>SPREADS</b>						
Contractual Lending Spread SG only <sup>21</sup>	50	50 – 40	50-40	50-40	50-40	40
Funding Cost Margin	NA	Average cost of the Pool <sup>4</sup>	Average cost of the Pool <sup>22</sup>	Average cost of Pool of Borrowings vs Libor <sup>23</sup>	Average cost of Pool of Borrowings vs Libor	Average cost of Pool of Borrowings vs Libor
Market Risk Premium	NA	NA	NA	NA	1 bp per year of maturity of loan	NA
Credit Risk Premium NSG only	N/A	NSG only	NSG only	NSG only	NSG only	NSG only
<b>CHARGES</b>						
Front-end fee	N/A	N/A	N/A	N/A	N/A	N/A
Commitment Fees <sup>24</sup>	75-100 bps	75-100 bps	75-100 bps	75-100 bps	75-100 bps	N/A
Statutory Commission	100 bps <sup>25</sup>					

<sup>19</sup> Introduced in 21-Jan-2009

<sup>20</sup> Initially the cost of funds was based on subscriptions, reserves and borrowings (actual plus estimate for the following year) but was changed in 1985 to be based on the cost of borrowed funds alone (actual and estimate for the following year)

<sup>21</sup> Since May-2005, the Bank's lending rate is set at 40 bps. A waiver of 20 bps was introduced in Jun-08 and suspended on 21-Jan-09

<sup>22</sup> Included in the calculation of the base interest rate

<sup>23</sup> Suspended in May-2005

<sup>24</sup> Exclusive of 50bps waiver; commitment fee was eliminated since May-2005

<sup>25</sup> Abolished in the mid-1980s

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## HISTORICAL PERSPECTIVE OF THE BANK'S LOAN PRODUCTS

### Fixed Rate Loan Products to 1990

1 Until 1990, fixed rate loans were the only lending instruments offered by the Bank and these were primarily funded from the available equity capital. The primary objective of the lending rate was to fulfill development objectives while covering operating expenses.

2 As lending operations expanded, the Bank depended more on borrowings and its financial strength in the capital markets became important. A lending rate methodology was therefore established in July 1982 when a borrowing cost-plus approach<sup>26</sup> was adopted for the determination of the lending rate. The Bank lending rate consisted of a base rate<sup>27</sup> plus a 50 basis points lending spread<sup>28</sup> which was fixed for the entire life of the loan. A commitment fee on undisbursed loans of 75 bps commencing from 90 days after commitment was applied to account for the time lag between commitments and disbursements. These were later adjusted to 100 bps and 45 days. The loan pricing principle was both cost pass through and coverage of administrative expenses. The fixed rate loan methodology achieved two objectives: competitiveness vis-à-vis the World Bank and an adequate level of income.

3 While the fixed rate loan gave stability and predictability to borrowers it exposed the Bank to increased interest rate risk at a time of increased reliance on borrowings to fund lending operations, primarily due to: (i) lending rates were fixed from the time of loan commitment; (ii) the substantial time lag between the loan commitment date and the final disbursement; and (iii) the wide maturity mismatch between loans averaging 15 to 20 years and borrowings generally not exceeding 10 years.

4 Management therefore explored alternative options to the Bank's lending rate methodology, including the pool-based variable lending rate system that had just been implemented by the IBRD.

### Pool-Based Variable Rate Loan Products 1990 - 1997

5 Resulting from the weaknesses inherent to the fixed rate loans highlighted above, in July 1990 the Bank introduced the multi currency pool based variable rate loan to enable a better cost pass between borrowing costs and lending terms and to allow for maximum funding flexibility.

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<sup>26</sup> ADB/BD/WP/87/136, Section 20.

<sup>27</sup> The base lending rate is obtained by computing the borrowing costs as the average of actual borrowings for the preceding 12 months and the projected future 12 months borrowings

<sup>28</sup> The spread or recovery rate of 50 basis points was determined after establishing that there was a high degree of correlation between the annual administrative expenditure and cumulative commitments. It is also important to note that the 50 bps lending spread for the coverage of administrative expenses was implemented consistently by all MDBs, namely IBRD, IADB and AsDB, in their lending rate methodology at that time.

6 The key feature of pool-based loans is that the lending rate is primarily based on the average funding cost of a qualified<sup>29</sup> pool of borrowings. The lending rate is obtained by adding a fixed lending spread of 50 basis points to the average cost of the pool of qualified borrowings (determined twice a year).

7 The main objectives achieved through the pool-based loans were: (i) stability of lending rates, (ii) increased equity for borrowers and (iii) increased flexibility in the funding strategy.

8 While the objectives of the pool based loan system were laudable, fundamental practical weaknesses emerged over time: (i) Pool-based rates can sometimes differ significantly from market rates, especially following a sharp decrease in interest rates when pool-based rates remain high, while market rates are much lower; (ii) the multi currency loan pooling system was intended to spread the exchange risk equally across borrowers and improve the management of currency risk for borrowers, they were still charged the same composite lending rate; (iii) the Bank tended to disburse low interest rate currencies to borrowers and retained high interest rate currencies in the liquidity portfolio which consequently increased the effective cost of borrowing from the Bank.

9 Given the weaknesses of the multi currency pool based loan product, Management sought to identify solutions for this product and to broaden the menu of loan products in order to enable borrowers to select currency and interest rate exposures that were more suitable to their individual debt service capacities.

**Table 01: Characteristics of Market Based Loan Products Introduced in October 1997**

Features of the Loan Products	Loan Products		
	Single Currency Variable Rate Loan	Single Currency Floating Rate Loan	Single Currency Fixed Rate loans
<b>Base rate</b>	VLR	Libor	Libor/Swap rate
<b>Funding Margin</b>	Included in the Base Rate	Applicable	Applicable
<b>Lending Spread</b>	50bps	50bps	50bps
<b>Commitment Fees</b>	75-100 bps (exclusive of waiver)		
<b>Front-end Fee</b>	Not Applicable		
<b>Reset Period</b>	1-Jan; 1-Jul	1-Feb; 1-Aug	1-Feb; 1-Aug (before rate fixing)
<b>Type of borrowers targeted</b>	Sovereign guaranteed borrowers (Middle Income Countries)		

### **The Bank's current Market Based Loan Products 1997 To Date**

10 In 1997 Management undertook a complete review of the Bank's lending products and proposed: (i) the replacement of the multi currency variable rate product with single currency products with alternative interest rate bases (variable, floating and fixed) and

<sup>29</sup> The calculation of the average cost of the pool of borrowings involves aggregating all accrued financial expenses, i.e. interest and amortization of discount or premium and other issuances expenses, over the six month period and dividing this figure by the average daily balance of outstanding borrowings in the pool during this period.

also authorized borrowers to convert their multi currency variable rate loans to the terms of the new single currency variable loan; (ii) single currency LIBOR based loans and fixed rate loans to ensure that borrowers can benefit from lending terms close to prevailing market rates. The key features of these products are summarized in Table 01 above.

11 These products were designed to reflect market-based features providing flexibility, a transparent comparative basis with those of other lenders operating in the continent and to be amendable to efficient intermediation. The pricing structure of the three new loan products remained unchanged from previous loan products as follows:

$$\text{Lending Rate} = \text{Base Rate} + \text{Funding margin} + \text{Lending spread}$$

12 The guiding principles in structuring the range of market based loan products were: flexibility for the borrowers, low intermediation risk<sup>30</sup> (avoiding interest rate and currency risk), minimum cost recovery and predictability of loan charges. The financial risks and the costs associated with borrowers' choice should not affect other borrowers' or the Bank's net income position. Further, the traditional cost "pass through" pricing was to be maintained so that the Bank can earn its basic lending spread and nothing more under all circumstances.

13 It is important to note that the lending margin for sovereign guaranteed loans (SG) is 50 basis points and is fixed in the loan agreement at the time of loan signing (or disbursement), irrespective of the loan currency.

14 It is important to note that the lending margin itself does not take into account the sub-libor funding cost margin (i.e. that because of the Bank's high credit standing and triple AAA rating it could fund itself at a cost lower than the six-month LIBOR). To ensure a full cost pass through pricing, the Bank returns the sub-Libor funding cost to the borrower through a funding margin which may result in a surcharge if the Bank's funding cost rises above six-month LIBOR.

### **Changes and simplification of the pricing structure in January 2005**

15 In January 2005, in the face of declining lending volumes and lower credit spreads in the financial markets, the Bank adjusted the pricing of market based loan products for the first time since their introduction. This change arose from three sources: (i) the large range of financing options offered by other multilateral institutions as well as domestic and international capital markets; (ii) the internal constraints faced by the Bank related to shortcomings in planning and programming, competitiveness of the range of the Bank's product offering and rigidity in lending processes and conditionality; and (iii) the evolution in the needs and preferences of borrowers.

16 An over-riding rationale behind these changes was a call from borrowers for simple, transparent and less rigid lending terms. In order to better understand the needs of borrowers and qualitatively improve its support to their development efforts, the Bank reviewed the entire set of products and processes of lending and non lending support to

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<sup>30</sup>The financial risks and the costs associated with borrowers' choices should not affect other borrowers' or the Bank's net income position.

respond to the issues outlined above. One of the main thrusts of this review was to revise the Bank's loan pricing through a set of measures:

- Simplify the pricing for sovereign borrowers with two actions: 1) eliminate the Variable Spread Loan with the suppression of the funding margin for all new sovereign loans and 2) decrease the lending spread from 50 bps to 40 bps
- Eliminate the market risk premium of one basis point per year of maturity of the loan for all new fixed rate sovereign and non sovereign loans in order to make the fixed rate loans more attractive to borrowers which relied with the Bank's interest rate strategy.
- Eliminate the commitment fee for all new sovereign guaranteed loans to reduce its financial impact and expand the range of the commitment fees for non-sovereign guaranteed operations from 0.5%-1% to 0%-1%.

17 This simplification of the loan pricing structure resulted in a single lending product known as the Fixed Spread Loan with a simple pricing based on a fixed spread of 40 basis points over Libor and no other charges. The objective was to strike a balance between simplicity and accuracy and to have a positive impact on client perceptions as well as aligning sovereign and non-sovereign pricing structures. In addition, any refinancing risks associated with the elimination of the funding margin would be borne by the Bank and not the borrower.

#### **Introduction of a 20 bps waiver on the lending spread in June 2008**

18 The Bank still faced challenges to meet its development objectives in a large portion of MICs. In 2008, MICs expressed their desire to see the Bank enhance its support for growth, poverty reduction and development.

19 Given the Bank's income prospects that allow some flexibility and following its key objectives to provide better lending terms and financial products to MICs, the Board approved the introduction of a lending margin waiver expected to be reviewed annually. This lending margin waiver was set at 20 basis points or 0.2%, bringing the Bank's effective pricing for sovereign and sovereign guaranteed operations to Libor plus 20 basis points. The waiver was applicable as follows: (i) to all new sovereign guaranteed loans approved by the Board and resulted in a reduction of the lending margin applicable during their entire life; and (ii) Any future modification of the lending margin waiver will only affect subsequent loan approvals.

#### **Key changes in pricing and loan products in January 2009**

20 In January 2009 the Bank revised the financial terms and conditions offered to its clients. The increase in the refinancing risk associated with the FSL prompted a revision of the current financial products and pricing conditions. Therefore, the Bank reviewed the loan pricing in order to ensure full cost pass through to its clients guaranteeing the Bank's loan income.

- Maintain the lending margin at 40 basis points;

- Temporary suspension of the interest rate waiver of 20 basis points associated with the floating and fixed rate loan with fixed lending spread.
- Maintain the zero front end and commitment fee policy decided in 2005.
- Temporary suspension of fixed spread loan products for new commitments given the lack of visibility about the duration and the magnitude of the impact of the crisis on the Bank's funding conditions.
- Re-introduction of a Variable Spread loan

21 Currently, the only Bank's standard loan product for the sovereign guaranteed borrowers is the Enhanced Variable Spread Loan (EVSL) approved by the Board on December 9<sup>th</sup> 2009.

## HISTORICAL LOAN INCOME ANALYSIS AND PROJECTIONS

**Table A1: Analysis of Loan Income and Coverage Ratios (2000 – 2009)**

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
<b>Gross Loans Outstanding</b>	<b>6,513</b>	<b>6,514</b>	<b>6,160</b>	<b>5,739</b>	<b>5,321</b>	<b>5,150</b>	<b>4,975</b>	<b>5,190</b>	<b>5,332</b>	<b>6,166</b>
<b>Change in Gross Loans Outstanding (in %)</b>	-3.59%	0.01%	-5.43%	-6.83%	-7.28%	-3.21%	-3.41%	4.33%	2.72%	15.65%
Ratio of Loans Funded by Debt	69.2%	66.4%	61.2%	63.7%	60.3%	62.6%	62.5%	61.7%	72.4%	80.1%
Loans Funded by Debt	4,510	4,325	3,767	3,655	3,206	3,226	3,108	3,201	3,860	4,942
<b>Change in Loans Funded by Debt (in %)</b>		-4.11%	-12.89%	-2.98%	-12.28%	0.63%	-3.68%	2.99%	20.60%	28.02%
<b>Average Outstanding Loans funded by debt</b>	<b>4,510</b>	<b>4,418</b>	<b>4,046</b>	<b>3,711</b>	<b>3,431</b>	<b>3,216</b>	<b>3,167</b>	<b>3,154</b>	<b>3,530</b>	<b>4,401</b>
<b>INCOME FROM LENDING SPREAD AND FEES</b>										
Income from Lending Spread ( 50 - 40 bps ) (1)	22.55	22.09	20.23	18.56	17.15	14.47	14.25	14.19	15.89	19.80
- Commitment Fees (2)	8.98	6.99	16.25	6.46	5.23	4.24	2.71	1.59	0.83	0.13
- Statutory Commission ( 3)	6.88	6.11	5.49	3.62	2.94	2.10	1.72	1.32	0.70	0.34
<b>Total Income from Lending Spread and Fees (4)= (1+2+3)</b>	<b>38.41</b>	<b>35.19</b>	<b>41.97</b>	<b>28.64</b>	<b>25.33</b>	<b>20.82</b>	<b>18.69</b>	<b>17.10</b>	<b>17.41</b>	<b>20.27</b>
<b>ADMINISTRATIVE EXPENSES</b>										
Operational Expenses (5)	20.38	16.07	15.51	24.15	20.67	21.64	22.07	26.66	30.63	39.30
<b>Change in Operational Expenses (in %)</b>		-21.12%	-3.51%	55.73%	-14.41%	4.69%	1.99%	20.82%	14.89%	28.29%
Non-Operational Expenses (6)	7.41	13.40	16.23	20.56	15.24	18.36	14.37	12.87	13.69	18.70
<b>Total Administrative Expenses (7) = ( 5+ 6)</b>	<b>37.78</b>	<b>29.47</b>	<b>31.74</b>	<b>44.71</b>	<b>35.90</b>	<b>40.00</b>	<b>36.44</b>	<b>39.53</b>	<b>44.32</b>	<b>58.00</b>
<b>Change in Total Administrative Expenses (in %)</b>		-21.99%	7.68%	40.87%	-19.69%	11.42%	-8.90%	8.48%	12.11%	30.87%
Provision (8)	25.21	35.28	-	-	-	-	31.51	-	-	-
<b>Loans Income less Operational expenses (9) = (4 - 5)</b>	<b>18.03</b>	<b>19.12</b>	<b>26.46</b>	<b>4.49</b>	<b>4.66</b>	<b>(0.82)</b>	<b>(3.38)</b>	<b>(9.56)</b>	<b>(13.22)</b>	<b>(19.03)</b>
<b>Loans Income less Total Administrative Expenses (10) = (4 - 7)</b>	<b>0.63</b>	<b>5.71</b>	<b>10.23</b>	<b>(16.07)</b>	<b>(10.58)</b>	<b>(19.19)</b>	<b>(17.75)</b>	<b>(22.43)</b>	<b>(26.91)</b>	<b>(37.73)</b>
<b>Net Loan Income (11) = (10 - 8)</b>	<b>(24.59)</b>	<b>(29.57)</b>	<b>10.23</b>	<b>(16.07)</b>	<b>(10.58)</b>	<b>(19.19)</b>	<b>(49.26)</b>	<b>(22.43)</b>	<b>(26.91)</b>	<b>(37.73)</b>
<b>COVERAGE RATIOS</b>										
Operational Expenses Coverage Ratio ( 4/5)	1.89	2.19	2.71	1.19	1.23	0.96	0.85	0.64	0.57	0.52
Operational Expenses & Provision Coverage Ratio 4/(5+8)	0.84	0.69	2.71	1.19	1.23	0.96	0.35	0.64	0.57	0.52
Total Administrative Expenses Coverage Ratio ( 4/7)	1.02	1.19	1.32	0.64	0.71	0.52	0.51	0.43	0.39	0.35
Total Administrative Expenses & Provision Coverage Ratio 4/(7+8)	0.61	0.54	1.32	0.64	0.71	0.52	0.28	0.43	0.39	0.35

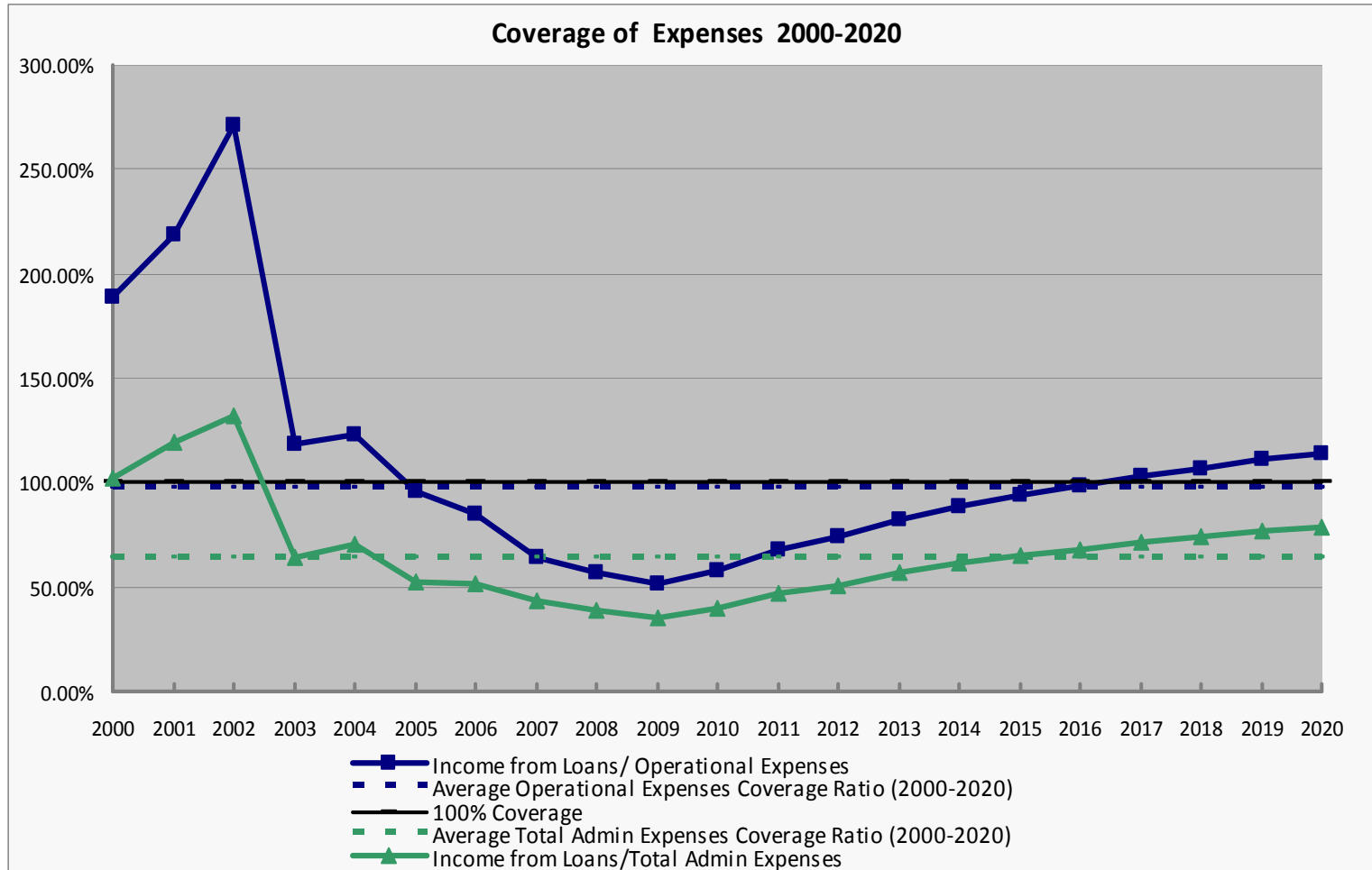
- Gross Loans Outstanding = Outstanding loans at year end; Average Outstanding Loans = Average of loans outstanding for two consecutive years
- The Ratio of Loans Funded by Debt is derived from the Net Income Allocation Methodology; Loans Funded by Debt = Gross loans outstanding \* Ratio of Loans Funded by Debt
- Income from Spread = Average outstanding loans funded by debt \* Lending Spread
- Administrative Expenses are derived from the Bank's actual administrative Budget figures realized at the year end into operational & non-operational expenses. These figures are calculated under ADB's cost sharing formula methodology.
- Sector, Country and Support departments expenses are allocated between operational and non-operational taking into account a ratio defined by the Budget.

**Table A2: Analysis of Loan Income and Coverage Ratios (2010 – 2020)**

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
<b>Gross Loans Outstanding</b>	<b>8,117</b>	<b>9,399</b>	<b>10,472</b>	<b>11,892</b>	<b>12,849</b>	<b>14,005</b>	<b>15,207</b>	<b>16,420</b>	<b>17,692</b>	<b>18,970</b>	<b>20,276</b>
<b>Change in Gross Loans Outstanding (in %)</b>	31.64%	15.80%	11.42%	13.56%	8.04%	9.00%	8.59%	7.97%	7.74%	7.23%	6.88%
Ratio of Loans Funded by Debt	83.5%	86.3%	88.9%	91.0%	92.4%	93.2%	93.7%	93.89%	93.93%	93.87%	93.89%
Loans Funded by Debt	6,779	8,114	9,306	10,821	11,867	13,056	14,246	15,417	16,617	17,808	19,036
<b>Change in Loans Funded by Debt (in %)</b>	37.17%	19.70%	14.70%	16.27%	9.67%	10.01%	9.12%	8.22%	7.79%	7.17%	6.90%
<b>Average Outstanding Loans funded by debt</b>	<b>5,860</b>	<b>7,446</b>	<b>8,710</b>	<b>10,064</b>	<b>11,344</b>	<b>12,462</b>	<b>13,651</b>	<b>14,831</b>	<b>16,017</b>	<b>17,212</b>	<b>18,422</b>
<b>INCOME FROM LENDING SPREAD AND FEES</b>											
Income from Lending Spread ( 50 - 40 bps ) (1)	26.42	33.18	38.52	44.14	49.25	53.49	57.98	62.41	66.83	71.30	75.84
- Commitment Fees (2)	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13
- Statutory Commission ( 3)	0.34	0.34	0.34	0.34	0.34	0.34	0.34	0.34	0.34	0.34	0.34
<b>Total Income from Lending Spread and Fees (4)= (1+2+3)</b>	<b>26.89</b>	<b>33.65</b>	<b>38.99</b>	<b>44.61</b>	<b>49.72</b>	<b>53.96</b>	<b>58.45</b>	<b>62.88</b>	<b>67.30</b>	<b>71.77</b>	<b>76.31</b>
<b>ADMINISTRATIVE EXPENSES</b>											
Operational Expenses (5)	46.26	49.49	52.70	54.28	55.91	57.59	59.32	61.10	62.93	64.82	66.76
<b>Change in Operational Expenses (in %)</b>	17.70%	6.99%	6.49%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
Non-Operational Expenses (6)	21.82	22.68	23.72	24.43	25.17	25.92	26.70	27.50	28.33	29.17	30.05
<b>Total Administrative Expenses (7) = ( 5+ 6)</b>	<b>68.07</b>	<b>72.17</b>	<b>76.43</b>	<b>78.72</b>	<b>81.08</b>	<b>83.51</b>	<b>86.02</b>	<b>88.60</b>	<b>91.26</b>	<b>93.99</b>	<b>96.81</b>
<b>Change in Total Administrative Expenses (in %)</b>	17.36%	6.02%	5.90%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
Provision (8)	9.49	11.36	13.03	15.15	16.61	18.28	19.94	21.58	23.26	24.93	26.65
<b>Loans Income less Operational expenses (9) = (4 - 5)</b>	<b>(19.37)</b>	<b>(15.84)</b>	<b>(13.71)</b>	<b>(9.68)</b>	<b>(6.19)</b>	<b>(3.63)</b>	<b>(0.87)</b>	<b>1.78</b>	<b>4.37</b>	<b>6.95</b>	<b>9.55</b>
<b>Loans Income less Total Administrative Expenses (10) = (4 - 7)</b>	<b>(41.19)</b>	<b>(38.52)</b>	<b>(37.44)</b>	<b>(34.11)</b>	<b>(31.36)</b>	<b>(29.55)</b>	<b>(27.56)</b>	<b>(25.72)</b>	<b>(23.95)</b>	<b>(22.22)</b>	<b>(20.50)</b>
<b>Net Loan Income (11) = (10 - 8)</b>	<b>(50.68)</b>	<b>(49.88)</b>	<b>(50.47)</b>	<b>(49.26)</b>	<b>(47.98)</b>	<b>(47.83)</b>	<b>(47.51)</b>	<b>(47.30)</b>	<b>(47.22)</b>	<b>(47.15)</b>	<b>(47.15)</b>
<b>COVERAGE RATIOS</b>											
Operational Expenses Coverage Ratio ( 4/5)	0.58	0.68	0.74	0.82	0.89	0.94	0.99	1.03	1.07	1.11	1.14
Operational Expenses & Provision Coverage Ratio 4/(5+8)	0.48	0.55	0.59	0.64	0.69	0.71	0.74	0.76	0.78	0.80	0.82
Total Administrative Expenses Coverage Ratio ( 4/7)	0.39	0.47	0.51	0.57	0.61	0.65	0.68	0.71	0.74	0.76	0.79
Total Administrative Expenses & Provision Coverage Ratio 4/(7+8)	0.35	0.40	0.44	0.48	0.51	0.53	0.55	0.57	0.59	0.60	0.62

- Projected loan approvals are based on the MTS assumptions and thereafter 5% increase is assumed based on the expected economic growth in RMCs.
- Budgeted expenses are considered for 2010-2012 while a 3% increase due to the inflation effect has been taken into account for the remaining period.
- The projected provisioning level ( 14 bps of outstanding loans) is based on the historical provisioning (2000- 2006) excluding of write back.

**Graph Annex 3- Total Administrative Expenses Coverage and Operational Expenses Coverage Ratios from 2000 to 2020**



**Table B: Projected Net Loans Income Analysis – Operational expenses only (2010 – 2020)**

Year	Change in Leading Spread	Base Case	Stress Test		
		Net Loan Income (Loan Income – Operational Expenses –Provisions)	Changes in Operational Expenses	Changes in Operational Expenses with Change in Cost Sharing Formula	Changes in Provisioning
			+10%	+18.5%	+10%
2010	+15bps	(28.6)	(33.2)	(37.14)	(35.4)
	+20bps	(28.5)	(33.1)	(37.04)	(35.3)
	+30bps	(28.3)	(32.9)	(36.85)	(35.1)
	+40bps	(28.1)	(32.7)	(36.66)	(34.9)
2011	+15bps	(26.2)	(31.2)	(35.38)	(34.3)
	+20bps	(25.9)	(30.9)	(35.06)	(34.0)
	+30bps	(25.3)	(30.2)	(34.41)	(33.4)
	+40bps	(24.6)	(29.6)	(33.77)	(32.7)
2012	+15bps	(24.7)	(30.0)	(34.47)	(32.2)
	+20bps	(24.0)	(29.3)	(33.79)	(33.3)
	+30bps	(22.7)	(28.0)	(32.44)	(32.0)
	+40bps	(21.3)	(26.6)	(31.09)	(30.6)
2013	+15bps	(21.4)	(26.8)	(31.42)	(29.3)
	+20bps	(20.2)	(25.7)	(30.27)	(31.0)
	+30bps	(15.6)	(23.3)	(27.96)	(28.7)
	+40bps	(15.6)	(21.0)	(25.66)	(26.4)
2014	+15bps	(17.4)	(23.0)	(27.75)	(27.2)
	+20bps	(15.6)	(21.2)	(25.95)	(27.5)
	+30bps	(12.0)	(17.6)	(22.35)	(23.9)
	+40bps	(8.4)	(14.0)	(18.75)	(20.3)
2015	+15bps	(14.1)	(19.9)	(24.80)	(22.2)
	+20bps	(11.6)	(17.3)	(22.21)	(24.6)
	+30bps	(6.4)	(12.1)	(17.04)	(19.4)
	+40bps	(1.2)	(7.0)	(11.86)	(14.3)
2016	+15bps	(10.5)	(16.4)	(21.45)	(19.8)
	+20bps	(7.0)	(13.0)	(18.00)	(21.3)
	+25bps	(0.1)	(6.1)	(11.11)	(14.4)
	+40bps	6.8	0.8	(4.22)	(7.5)
2017	+15bps	(6.8)	(12.9)	(18.11)	(17.3)
	+20bps	(2.5)	(8.6)	(13.78)	(17.9)
	+30bps	6.2	0.1	(5.12)	(9.2)
	+40bps	14.8	8.7	3.54	(0.6)
2018	+15bps	(3.2)	(9.5)	(14.81)	(35.3)
	+20bps	2.1	(4.2)	(9.57)	(14.5)
	+30bps	12.6	6.3	0.92	(4.1)
	+40bps	23.0	16.8	11.40	6.4
2019	+15bps	0.5	(6.0)	(11.51)	(34.0)
	+20bps	6.6	0.2	(5.35)	(11.2)
	+30bps	18.9	12.5	6.95	1.1
	+40bps	31.3	24.8	19.26	13.4
2020	+15bps	4.1	(2.6)	(8.29)	(15.0)
	+20bps	11.1	4.4	(1.23)	(7.9)
	+30bps	25.2	18.6	12.88	6.2
	+40bps	39.3	32.7	26.99	20.3

### Lending Spread Adjustment- Impact on Net Income and RCUR

Different simulations have been run to assess the impact of the increase in the Bank's lending spread on the Risk Capital Utilization Rate (RCUR) and Net Income assuming a 200% capital increase with 6% paid in capital in 2011. As shown in Table C below, a minimum increase of 53 bps in the Bank's lending spread is required to maintain the RCUR below the 100% limit up to the end of GCI-VI period in 2020. With an increase of 20 bps, the RCUR would be maintained below the 100% limit until 2018. Such increase would also improve the Bank's risk bearing capacity by a cumulative amount of UA 144 million in 2020.

**Table C – Projected Bank's RCUR and Net Income from 2010-2020**

RCUR - With GCI	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Base Case	68.2%	77.8%	85.1%	91.0%	95.1%	98.2%	99.8%	100.6%	100.2%	102.4%	103.9%
+20 bps	68.2%	77.8%	85.0%	90.9%	94.9%	97.8%	99.3%	99.8%	99.2%	101.2%	102.4%
+30 bps	68.2%	77.8%	85.0%	90.8%	94.7%	97.6%	99.0%	99.4%	98.8%	100.6%	101.6%
+53 bps	68%	78%	85%	91%	94%	97%	98.3%	98.6%	97.7%	99%	100%
Net Income	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Base Case	150	178	201	256	307	356	396	417	437	450	472
+20 bps	151	180	204	262	315	367	411	436	460	477	503
+30 bps	151	181	206	264	319	373	419	445	472	491	519
+53 bps	151	182	210	270	329	386	437	468	499	522	555
Cumulative increase of											
+20bps		+2	+5	+10	+18	+29	+44	+63	+86	+113	+144

## Glossary

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**Currencies:** The Bank may finance a project in one or several currencies approved as lending currencies - currently USD, EUR, JPY and ZAR. In principle, the Bank can also consider lending in other currencies in which it can fund itself efficiently and for which there is sufficient demand. Disbursements, principal repayments and all loan charges are denominated in the loan currency chosen by the borrower

**Loan Maturity:** The Bank provides long-term financing to suit the needs of its borrowers; Sovereign Guaranteed Loans may have a maximum maturity of up to 20 years, inclusive of the grace period. Maturity restrictions may apply to certain currencies and product types, depending on market conditions.

**Grace period:** Grace periods are dependent on the specific characteristics of the project and the time required for its implementation, but should generally not exceed 5 years. In exceptional cases, grace periods longer than 5 years may be considered subject to satisfactory justification of project requirements by the borrower. The grace period starts from the date of signature of the loan agreement.

**Interest Rate terms:** Interest rates on Bank loans are expressed as nominal rates. Interest and any other charges are computed on the basis of the actual number of days elapsed and a 365-day year.

The Bank provides several alternative interest rate mechanisms:

a-For Enhanced Variable Spread Loans, the applicable rate of interest is the sum of three components – the chosen base rate with a free fixing option plus a lending margin (or spread) plus a funding margin.

b-For Fixed Spread Loans<sup>31</sup>, the applicable rate of interest is the sum of two components – the chosen base rate plus the lending margin.

**Base Rate:** To provide its borrowers with the flexibility to match the interest rate structure of their loans with their individual financial needs, the Bank offers three principal structures for the base lending rate: floating base rate, fixed base rate, and variable base rate.

**Floating Base Rate:** The floating base rate is determined for each loan currency and reset frequency based on the Bank's selected reference interest rate in each market. For USD and JPY, the Bank's standard floating base rate is 6-month Libor, while for EUR 6-month Euribor is used; these rates reset

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<sup>31</sup> The Fixed Spread Loan product is currently temporarily suspended.

semi-annually (value February 1 and August 1). For ZAR, the Bank's standard floating base rate is 3-month Jibar; this rate resets quarterly (value February 1, May 1, August 1 and November 1).

**Fixed Base Rate:** The principal feature of the fixed base rate is that it remains fixed for the life of the loan. However, because loans are generally disbursed in several tranches and the rate applicable to each loan tranche is fixed independently, a loan with a fixed base rate is usually initially composed of several tranches each with a different fixed base rate. The fixed base rate for each loan tranche is computed by the Bank as the inter-bank swap market rate corresponding to the principal amortization schedule of that tranche. When the disbursement of a loan is complete, the Bank gives its borrowers the option to consolidate multiple loan tranches into a single equivalent structure to simplify the future administration of the loan.

**Variable Base rate:** The variable base rate uses the Bank's historical average cost of funding of designated pool of borrowings in each currency as its reference. It is adjusted semiannually on January 1 and July 1. Unlike the floating base rate, which closely follows market interest rates, the Bank's variable base rate adjusts very slowly to changes in market interest rates.

**Funding Margin<sup>32</sup>:** The funding margin is the semester weighted average of the currency-specific cost spread relative to Libor/Euribor/ Jibar of the Bank debt allocated to fund all single currency floating rate loans in the loan currency. It is computed twice a year, for value 1 January, 1 July, based on allocated borrowings in the semester ending 31 December and 30 June.

**Lending Margin:** The lending margin is a rate premium expressed as a nominal interest, determined by the Bank and is independent of the base rate chosen; it remains unchanged throughout the life of the loan.

**Front-End Fee:** The front-end fee is designed to partially compensate the Bank for the costs associated with processing a loan request and preparation of the documentation for loan approval. It is only charged on an approved loan. It is not reimbursed if the loan is subsequently cancelled. The front-end fee is a percentage of the loan amount. The fee is payable before or at loan signature, however when market and/or conditions warrant, the frontend fee may be paid up to thirty (30) days after loan signature or as agreed among co financiers in co-financed projects.

**Commitment Fee:** The commitment is a charge that the Bank's applies to the borrowers for holding a loan available. The commitment fee starts to

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<sup>32</sup> The funding margin is only applicable for variable spread loans products

accrue at future date after loan signature. The commitment fee is payable on each payment date.

**Premium:** The premium is based on current market interest rates, loan interest rate and repayment structure of the remaining term of the loan. The premium will reflect the Bank's cost of redeploying the prepaid funds or unwinding the hedging transactions attached to the loan.

**Credit Default Swap:** A Credit Default Swap is a financial instrument used to transfer the risk of default of a borrower to a third party entity. In the context of the Bank's activity, such product can be used not for an insurance purpose but more to release the risk capital used by a country.

**Risk Capital Utilization Rate (RCUR):** The RCUR is the risk based limit which caps the total risk assumed by the Bank through all its operations (lending, funding, investment and other operational activities) to the total available risk capital (Paid-in Capital plus Reserves).

**Structure of the Bank's operating costs:** The bank's operating costs comprise of operational and non operational expenses.

**Non-operational Expenses:** The non operational expenses are the costs associated with other institutional programs not directly linked to operations

**Operational Expenses:** The operational expenses are composed of two groups of expenses; (i) direct lending cost i.e. expenses directly linked to lending operations (direct financing of project cycle activities having one to one relationship with lending); non-lending services (Analytical works, ESW&CSP and activities to maintain relationships with borrowing countries); and cost associated with cross cutting issues or provision of global/regional public goods; (ii) lending support cost that are associated with legal, treasury, disbursements, billing, procurement and post evaluation etc.

**Expected Losses:** Expected losses are the statistically probable level of losses associated with a given risk class. They represent a cost of doing business and are generally expected to be absorbed by operating income.

**Cost-Pass-Through:** The cost-pass-through principle lead the Bank to adjust its menu of products with a view to ensuring a full pass through of its borrowing costs to its clients, thereby safeguarding its financial integrity and its ability to remain a stable source of long term funding

**Impairment:** Under the IAS 39, a financial asset/group of financial assets is impaired and impairment losses are incurred if, and only if: (i) there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a "loss event"); and (ii) the loss event/events has an impact on the estimated future cash flows of the financial asset/group of financial assets that can be reliably estimated.