ADB's Financial Structure and Resource Mobilization: An Introduction

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ADB

Objectives and Disclaimers

- Gain basic understanding of how ADB functions as a financial institution
- Focus on ADB's Ordinary Capital Resources (OCR)
- Focus on concepts, not numbers
- Numbers are for illustrative purposes only
- Official figures are contained in ADB's annual financial statement
- Projections are highly sensitive to assumptions. Financial projections should always be read with its set of assumptions

ADB is a Unique Institution

Our name says it all:

Asian

Development

Bank

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ADB's Business Model

- ADB borrows from international capital market as well as receiving paid-in capital from shareholders
- ADB then:
  - lends to public sector borrowers with sovereign guarantee at a uniform price, with ADB passing through the cost of funds to borrowers, together with a 40bp lending charge
  - lends to public and private sector borrowers without sovereign guarantee at market price
  - participates in equity investment
- Cash flow and income from lending and investment are used to repay borrowings from capital market and to increase equity
- ADB's business model rests on its AAA credit ratings

Three Pillars to Support ADB's AAA Ratings

- Shareholder support
- Preferred creditor status and sovereign guarantee
- Prudential financial policy framework and practices

Three Pillars to Support ADB's AAA Ratings

1. Shareholder support

- shareholder's callable capital provides the ultimate safeguard to bond investors
- Potential call on callable capital indicates grave financial situation and sends a very serious negative message to the capital markets
- Therefore, the use of callable capital is not envisaged
- ADB's prudential financial management framework and practices serve to prevent such a call on callable capital

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Three Pillars to Support ADB's AAA Ratings

2. Preferred creditor status and sovereign guarantee

- member governments grant ADB loans preferential access to foreign exchange in the event of a country foreign exchange crisis
- Preferred creditor status is not a legal status, but embodied in practice and consistent universal recognition
- Sovereign guarantee on public sector projects provide assurance of timely repayment of loans by project entities, cross-default provides additional safeguard

Three Pillars to Support ADB’s AAA Ratings

3. Prudential financial policy framework and practices

- “The Bank shall be guided by sound banking principles in its operations.” [ADB Charter Article 14 (xiv)]
- Financial policy framework defines the financial boundaries and benchmarks (capital adequacy, ALM, etc.)
- Best practices in daily financial management, supported by analytical tools
- Forward looking and long-term perspective in ensuring sustainability of future financial strength
- Independent Risk Management Unit to ensure credit quality-at-entry, portfolio credit quality, treasury risk compliance etc
- ALCO to discuss financial management and compliance issues
- Quarterly report from TD and RMU to the Board

ADB's Simplified Balance Sheet Structure

as of 30 June 2007 ($ billion)			
Assets		Liabilities and Equity	
Loans with S. Guarantee	26	Outstanding Borrowings	30
Loans without guarantee	1	Equity (Paid-in Capital,	13
Equity Investment	1	Reserves & surplus, etc.)	
Liquidity Investments	15		
Total Assets	**43**	**Total Liabilities & Equity**	**43**

Notes: Numbers are simplified and rounded for illustration purpose only.

- Two major income assets:
  Loans and Liquidity investments
- Two funding sources for assets:
  Borrowings and equity

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ALM Attribution and Income Sources

Income ($million)	Asset	Liability and Equity
96 + 0	Sovereign Guaranteed Loans $26b 5%	Borrowing $24b 4.6%
8 + 92		Equity $2b 0%
20 + 0	N.S.G. Loans $1b 7%	Borrowing $1b 5%
30 + 50	Equity Inv. $1b 8%	Equity $1b 0%
Commitment Fee 50 + 0		
0 + 450	Liquidity Inv. $10b 4.5%	Equity $10b 0%
5 + 0	Liquidity Inv. $5b 5.1%	Borrowing $5b 5%

209 + 592 = 801 – admin exp 170 = net income 631

1. Equity carries no direct financial cost to ADB, earns full interest rate; thus, it is the primary source of net income, whether funding loans or investments
2. Loan charge (lending spread and commitment charge) provides secondary but important source of income, enough to cover expenses
3. Borrowings are neutral to net income due to "cost-pass-through" mechanism
4. AAA ratings ensure a small but positive earnings on liquidity funded by borrowings
5. Interest rate has the most significant impact on ADB's income; 1% change in interest rate translates into approx. $130 million difference in income

Notes: Tables and charts for illustration purpose only. Rates are not actual.

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Capital Adequacy, Liquidity, Net Income and Constraints

- Equity capital and liquidity provide safeguards in normal operations and in financial crisis
- ADB needs to manage two objectives during a potential financial crisis:
  - Still financially sound if substantive portions of ADB loans fall into arrears, and
  - Have sufficient liquidity for normal operation and increased lending when needed, even when access to capital market becomes difficult
- ADB's capital adequacy is defined by its Equity-to-Loan ratio (ELR), with minimum target set at 35%
- Liquidity level should sustain lending for 18 months without access to capital market, subject to statutory constraints
- Net income critical to grow ADB's financial capacity and to be deployed for other developmental purposes
- ADB's financial constraints include Lending Authority, Borrowing Authority and ELR

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Lending and Borrowing Authorities

Lending Authority	
Subscribed capital	53.7
Reserves	10.3
Outstanding loan commitment	(44)
Guarantees	(1)
Equity Investment	(1)
Lending Headroom	**18**

Borrowing Authority	
Callable capital from non-borrowing members	30.9
Paid-in capital and reserve	13.9
Borrowings	(30.4)
Guarantees	(1.3)
Borrowing Headroom	**13.1**

Note: as of June 2007. Numbers are in US$ billions and may not add up due to rounding.
Source: Controller Department's Monthly Financial Report.

- ADB's capacity is limited to its lending authority and borrowing authority
- Lending headroom is a function of project approval
- Borrowing headroom is a function of disbursement and other cash flow needs

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ADB's Financial Position, 1994–2006

($ million)

	Account	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Assets	Loan Outstanding	16,465	17,492	16,070	18,788	24,698	28,271	28,155	28,659	29,145	25,398	24,197	23,479	26,177
Assets	Liquidity Investment	5,645	6,069	6,332	7,042	8,076	8,199	7,533	8,265	9,029	11,441	12,021	12,232	13,136
Liability & Equity	Borrowing Outstanding	13,684	14,599	13,663	17,494	23,744	26,285	25,367	24,881	25,905	26,264	23,921	24,398	27,608
Liability & Equity	Equity	8,477	9,272	9,666	9,302	10,063	10,563	10,834	10,874	12,352	12,852	13,267	12,275	13,142
Net Income		513	660	572	467	464	450	626	714	753	614	386	391	652

Notes: Numbers do not add up as certain classes of asset/liability were omitted. Income after expenses includes appropriations. 1994–2004 numbers are based on statutory reporting figures from ADB's Annual Reports. 2005 and 2006 figures are from Monthly Financal Report (CTL). Numbers are for illustrative purposes only

Source: ADB annual Financial Statements, Monthly Financial Report, Quarterly Treasury Reports

- Loan portfolio grew through the Asian financial crisis
- Sharp decline in US dollar interest rate caused large prepayment in legacy loans
- Allocable income stayed positive through ADB's history. 2004–2005 income lowest during the period
- Equity steadily accumulated to strengthen ADB's financial capacity

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Allocation of 2006 Income

Allocable Net Income for 2006:	$652 million
Allocation to Ordinary Reserve:	$286 million
Transfer to Surplus:	$286 million
Transfer to ADF:	$ 40 million
Transfer to RCIF:	$ 40 million

- Proposed to maintain the waivers of (i) 20 bps lending spread, and (ii) 100 bps front-end fee for 2007/2008
- Introduced new waivers on commitment fee of 50bp/10bp for program and project loans for 2007/2008
- Subject to projected levels of net income, plans to propose continued waivers in 2008/2009 and 2009/2010

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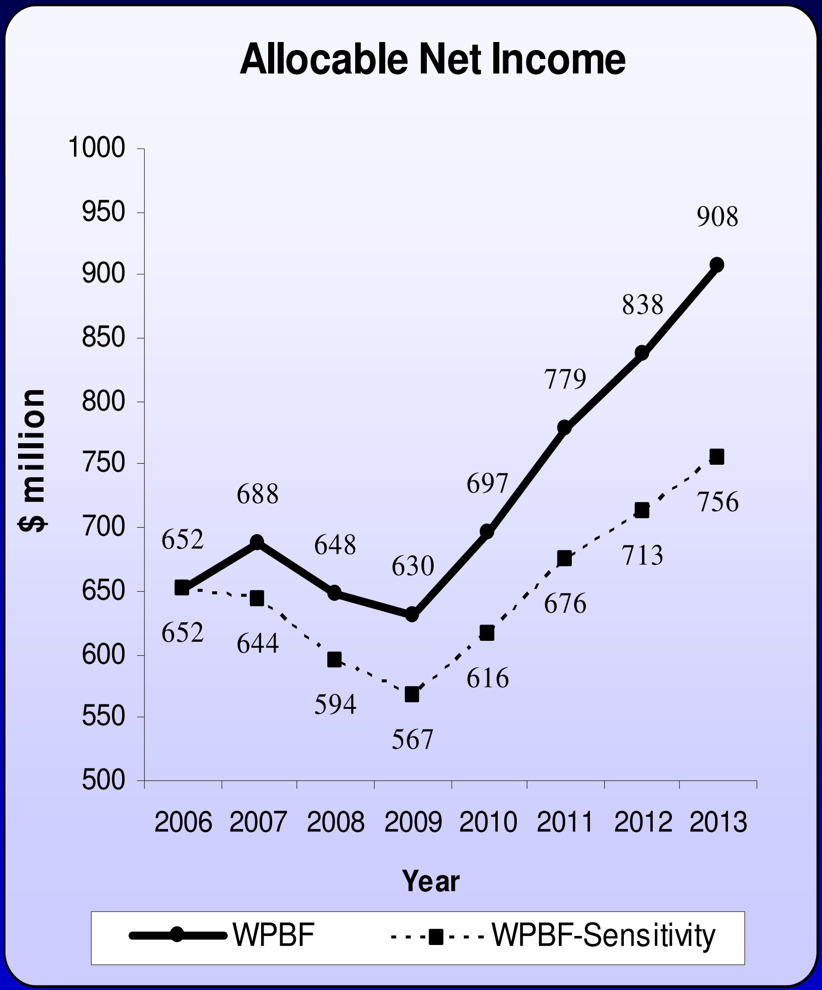
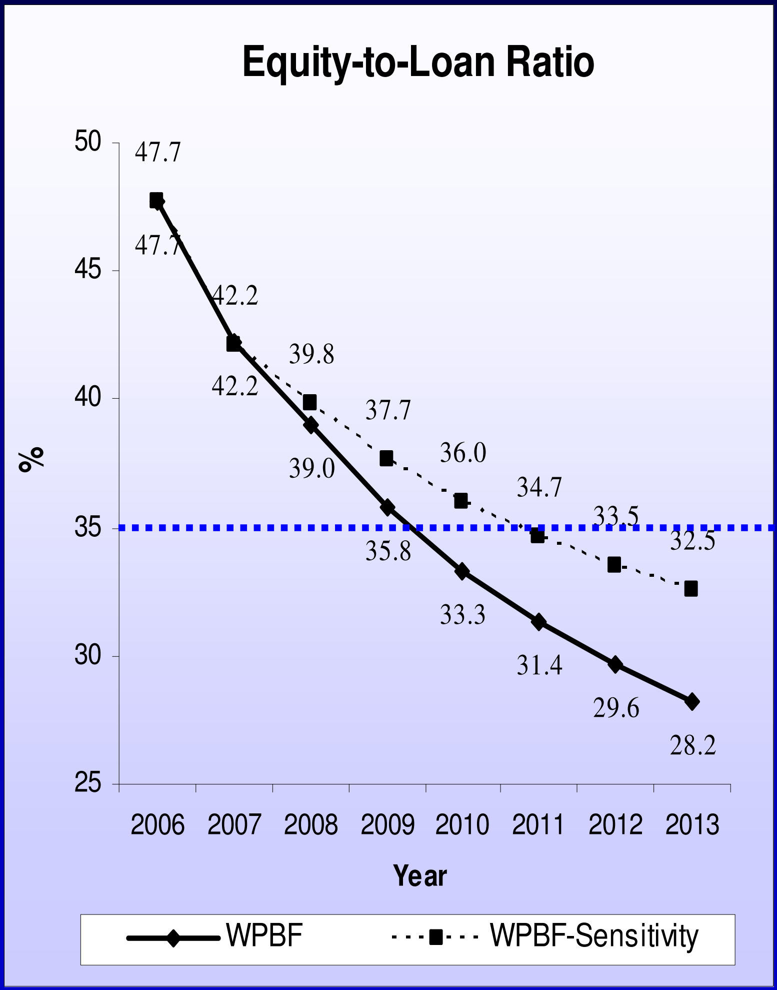
Projections: Allocable Net Income and ELR

($ million, %)





Note: Projection is highly sensitive to assumptions. This projection should be read together with the assumptions.
Source: Treasury Report: Second Quarter 2007.

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Projected Lending and Borrowing Headrooms

($ million)

Indicator/Scenario	Actual 2006	2007	2008	2009	2010	2011	2012	2013
Lending Headroom								
WPBF	18.2	13.0	7.0	2.0	(3.5)	(9.1)	(15.0)	(20.9)
WPBF Sensitivity	18.2	15.5	11.9	9.4	5.5	2.1	(1.2)	(4.2)
Borrowing Headroom								
WPBF	15.8	13.7	9.7	5.8	0.9	(3.8)	(8.9)	(14.1)
WPBF Sensitivity	15.8	13.7	11.2	9.3	6.6	4.2	1.6	(0.9)

( ) = negative, WPBF = work program and budget framework.

[a] Do not include the foreign exchange safety margin of $3.0 billion as noted in ADB. 2007. *Review of the Asian Development Bank's Resource Position.* Manila.

Note: Projection is highly sensitive to assumptions. This projection should be read together with the assumptions.
Source: Treasury Report: Second Quarter 2007.

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Financial Projections Assumptions (for WPBF case)

($ billion, %)

Projection Assumptions	2006 Actual	2007	2008	2009	2010	2011	2012	2013
Loan Portfolios								
Approvals – Sovereign excluding MFF	4.6	5.8	5.5	5.7	4.6	4.8	5.1	5.3
Approvals – Loans under MFF	0.9	1.9	2.3	1.5	3.5	3.7	3.9	4.1
Approvals – Nonsovereign	0.6	0.9	0.9	1.0	1.0	1.0	1.1	1.1
Approvals – Total	6.1	8.6	8.7	8.2	9.1	9.6	10.0	10.5
Disbursements – Sovereign and Nonsovereign	4.4	6.1	4.6	4.9	5.0	5.1	5.4	5.5
Disbursements – Sovereign MFF	0.0	0.4	1.4	1.9	2.2	2.6	3.2	3.7
Repayments	(1.3)	(1.3)	(1.6)	(1.8)	(2.2)	(2.5)	(2.8)	(3.2)
Prepayments	(0.5)	(0.5)	(0.2)	(0.1)	-	-	-	-
Net Change in the Loan Portfolios	2.6	4.7	4.1	4.9	5.1	5.3	5.8	5.9
Cancellations on Future Loans (%)		5.0	5.0	5.0	5.0	5.0	5.0	5.0
Spread on Nonsovereign Loans (%)		2.5	2.5	2.5	2.5	2.5	2.5	2.5
Provision for Future Private Sector Loans (%)	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
Return on $ Prudential Liquidity Portfolio (%)	4.4	4.7	4.5	4.5	4.5	4.5	4.5	4.5

Source: Treasury Report: Second Quarter 2007.

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Four Functions of Treasury Department

ALCO Supervision/Quarterly Treasury Report to Board of Directors

Financial Policy and Planning Division

- Overall capital adequacy
- Financial projection
- How much to borrow
- How much to charge
- How to allocate income
- How much liquidity
- Investment policies
- Asset Liability allocation
- ADF Replenishment/ financial management

Funding Division

- Capital market operations
- Global borrowings
- Private placement
- Local currency borrowings
- Borrower services/workshops

Investments Division

- Liquidity Investment
- Internal portfolio management
- External portfolio management

Treasury Services Division

- Disbursements/Payments
- Bank acct/cash management
- Investment Settlement
- Business Contingency
- Treasury IT

Compliance monitoring by the independent Risk Management Unit (RMU)

Recent TD Activities

- Established the Asset Liability Management Committee (ALCO) in 2004
- Introduced, reviewed and updated the following financial policies since 2005:
  - Asset Liability Management Policy
  - Liquidity Policy
  - Investment Strategy and Authority (with RMU)
  - Local currency loan products
  - Enhanced features of ADB's loan products
  - ADF SDR Currency
  - ADF Financial Framework
- Introduced new OCR and ADF financial projection systems (2005–2006) with enhanced analytical capabilities
- 2007 funding needs approx. $9 billion, $8.6 billion borrowed year to date with 92 transactions, 5.2 years average maturity in 13 currencies.
- Launched the $10 billion Asian Currency Note Program in 2006 to facilitate Asian bond market development
- $24 billion liquidity under investment management (including OCR, ADF and other trust funds)
- 200,000 SWIFT messages and over one trillion dollar volume of transactions
- ADF X Replenishment exercise

Conclusions and Observations

- AAA ratings critical for ADB's business model
- ADB is financially very sound, with dedicated team ensuring its continuity
- ALCO provides oversight on financial management
- Quarterly Treasury Report keeps the Board informed regarding latest projections and analysis
- All financial policy changes and updates are subject to Board approval
- Level of loan charge reviewed annually and subject to Board approval
- Allocation of net income proposed by Management, endorsed by Board of Directors and approved by Board of Governors annually
- TD submits annual borrowing program paper for Board approval
- TD submits annual resource review for Board information or action

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Thank You

Q & A