ADB's New Capital Adequacy Framework

Capacity Building Program for Pakistan Government Officials

19-23 August 2024| ADB Headquarters, Philippines

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New Capital Adequacy Framework (CAF)

- Approved by the Board in September 2023.
- Aims to maintain AAA rating and market access at all times. Protects the risk-bearing capacity without relying on callable capital.
- Reserves capital for eight material risk exposures.
- Capital adequacy reported to Management and the Board on a quarterly basis.
- Reviewed on a 3-year basis.

Capital Utilization Ratio (CUR)

Ratio of total economic capital used versus usable equity

Used for:

1. Point-in-time measurement
2. Long-term financial planning

3 zones:

- Safe zone (up to 90%)
- Warning zone (>90% to 95%)
- Hazard zone (>95% to 100%)

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Risk Appetite

Lowering the Prudential Level of Capitalization

Shareholders guided ADB to “**lower the prudential level of capitalization to the intersection between extremely strong and very strong”**, whilst **strengthening the following related aspects of the risk management framework**:

Sovereign Risk Appetite

Introduce a risk appetite that balances between the development objectives and sound banking principles.

- Low risk: 50% of ADB’s usable equity
- Moderate risk: 40% of usable equity
- Significant risk: 30% of usable equity
- High risk: 25% of ADB’s usable equity

Countercyclical Lending Buffer. Establish an explicit countercyclical lending buffer ($12 billion) to provide certainty on ADB’s capacity to increase lending to respond to large crises.

Recovery Plan. To ensure that ADB will remain adequately capitalized even in the face of severe financial stress.

- Management to submit a timebound capital management plan for board approval when CUR is expected to exceed 90 and 95% respectively.
- Specified capital restoration measures will automatically be implemented if CUR >100% and there is no Board approved recovery plan with 45 days.

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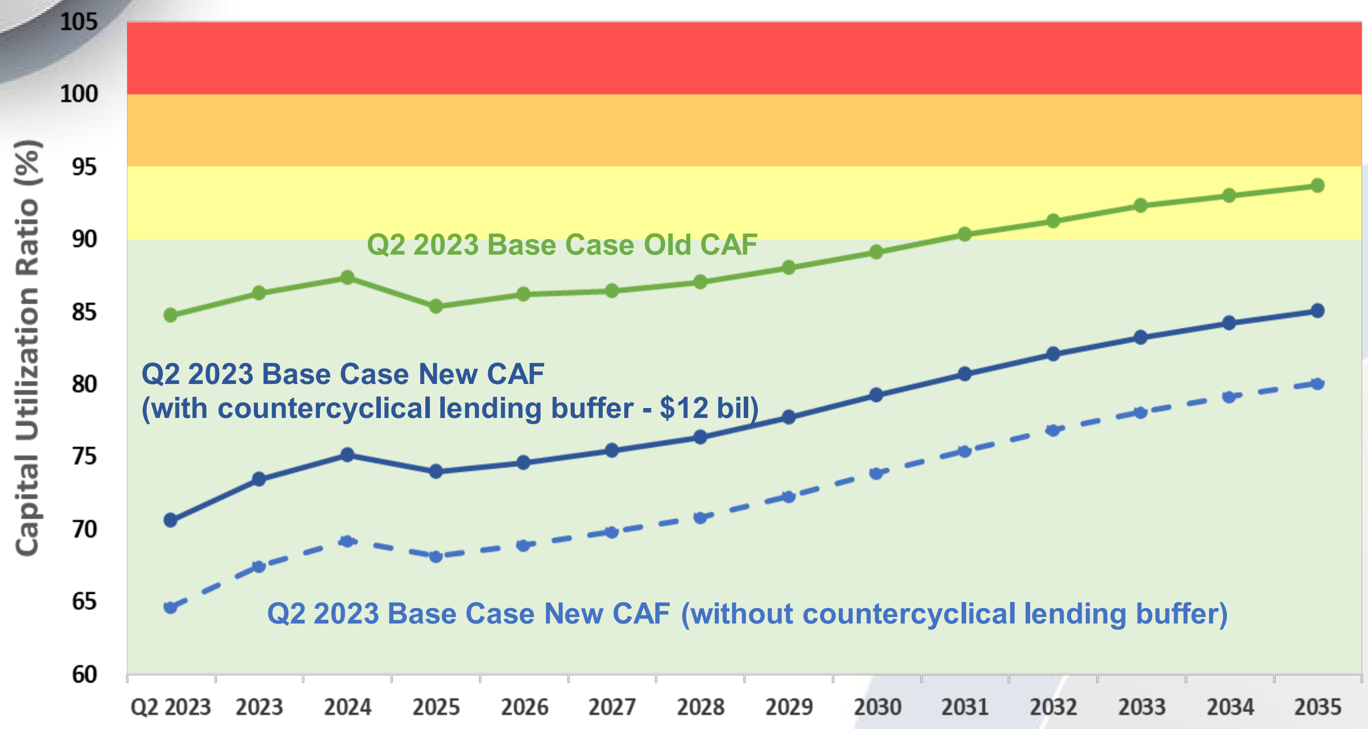
Impact on Perceived Capitalization



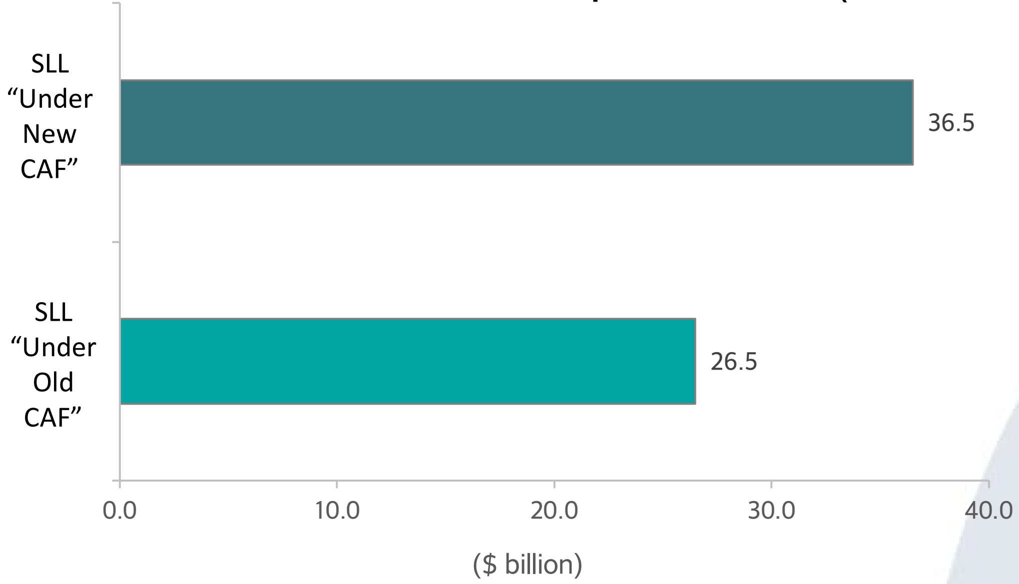
bil = billion, Q = quarter.

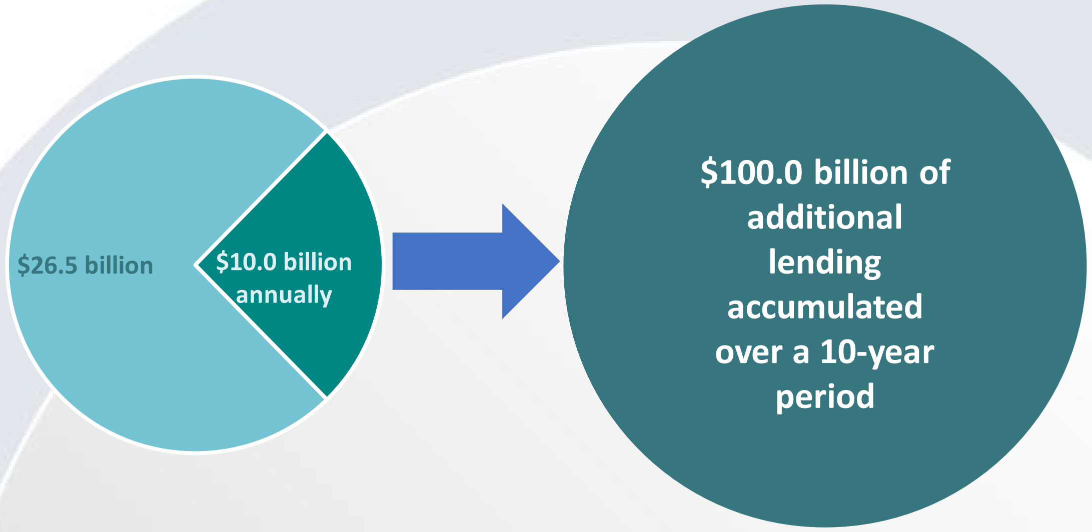
- The changes to risk measurement in aggregate, lower the estimate of capital required for the material risks faced by ADB.
- Under the old framework and base-case assumptions as of Q2 2023, the CUR in Q2 2023 is 84.7%.
- Under the new framework, the CUR in Q2 2023 would decrease to 70.6%.

Implication on Sustainable Level of Lending (SLL)

With a lower minimum level of capitalization, ADB´s lending capacity increases.

The SLL is estimated to increase from $26.5 billion to $36.5 billion, equal to an addition of $10.0 billion per annum ($100.0 billion over the 10-year planning horizon).





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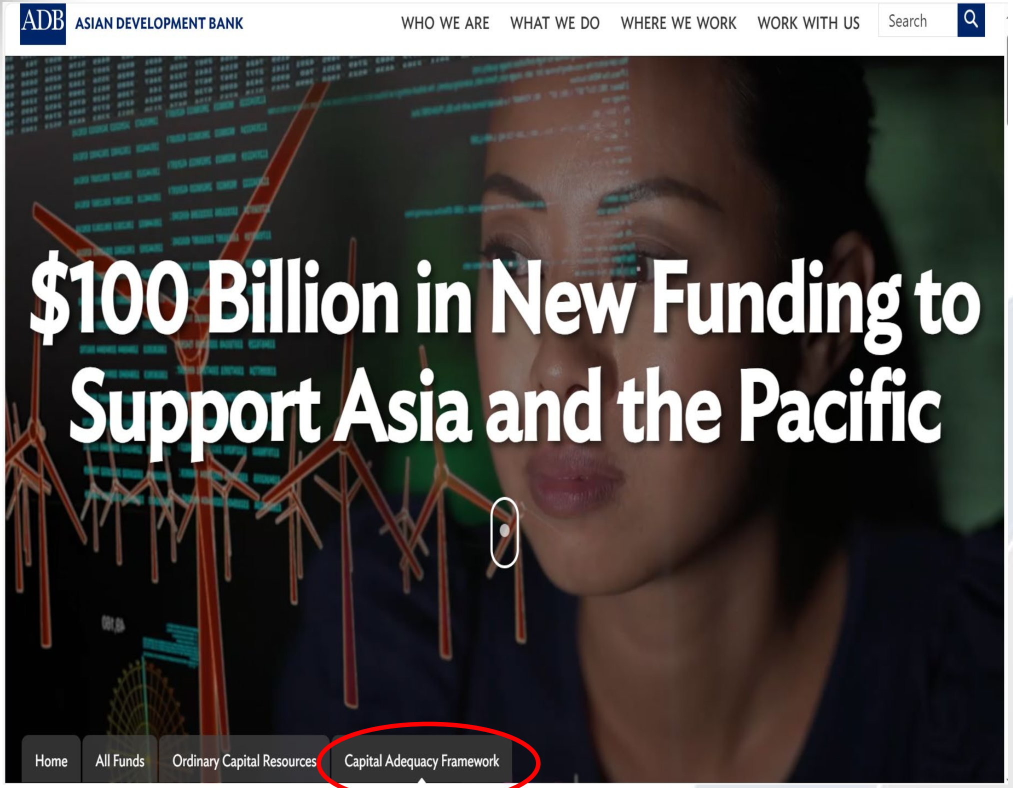
Notes:

1. Based on financial projections as of Q2 2023 (25 August 2023)
2. The SLL is highly sensitive to the modeling of assumptions such as disbursements, future loan terms, interest rate and return forecasts, and credit quality of the portfolio.

Visit ADB's CAF page:
[New Capital Adequacy Framework | Asian Development Bank (adb.org)]

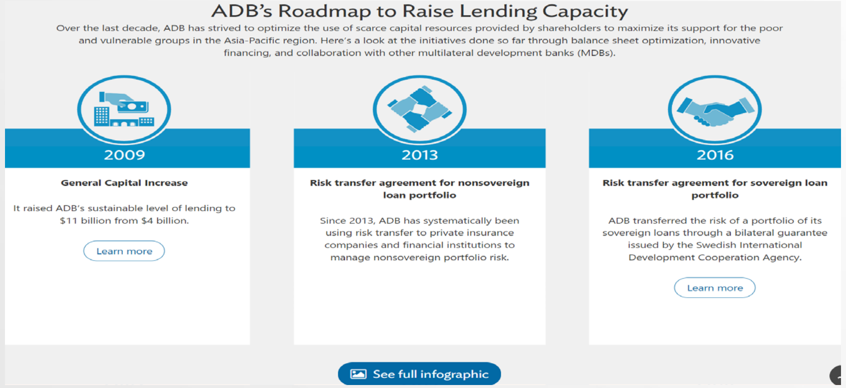


ADB Capital Management Reforms Unlock $100 Billion in New Funding Over Next Decade to Support Asia and the Pacific

ADB approved capital management reforms that unlock $100 billion in new funding capacity over the next decade to address the region's overlapping, simultaneous crises. The expansion of available funds will be further leveraged through mobilizing private and domestic capital to move from the billions to trillions required to tackle the climate crisis.

Q&A: ADB's Capital Management Reforms

A Capital Adequacy Framework aims at identifying the optimal balance of a financial institution's assets, liabilities, and risks. Capital can be considered adequate if the financial institution is able to honor its obligations if its debtors are unable to pay back what they borrowed or if the market value of liquid assets falls.



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Exposure Limits on ADB’s Operations Portfolio

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The Case for Exposure Limits: Background

AAA

The purpose of the limits framework is to limit concentration risk and support equitable access to ensure ADB’s continued viability as a lending institution. This is consistent with the objective to safeguard the AAA rating and ADB’s ability to access financing at the lowest sustainable cost.

Article 2 of the ADB charter states ADB: “shall utilize the resources at its disposal for financing development of the developing member countries in the region, giving priority to those regional, sub-regional as well as national projects and programs which will contribute most effectively to the harmonious economic growth of the region as a whole, and having special regard to the needs of the smaller or less developed member countries in the region”. A formal limit framework will promote equitable access to ADB’s resources.

Article 14 (xii) states that: “The Bank shall pay due regard to the desirability of avoiding a disproportionate amount of its resources being used for the benefit of any member”. A formal limit framework will promote equitable access to ADB’s resources.

Article 14 (xiv) states that ADB should adhere to sound banking principles. A robust limit framework covering all borrower categories - including sovereigns - will align with best practices as applied by peer MDBs and commercial banks.

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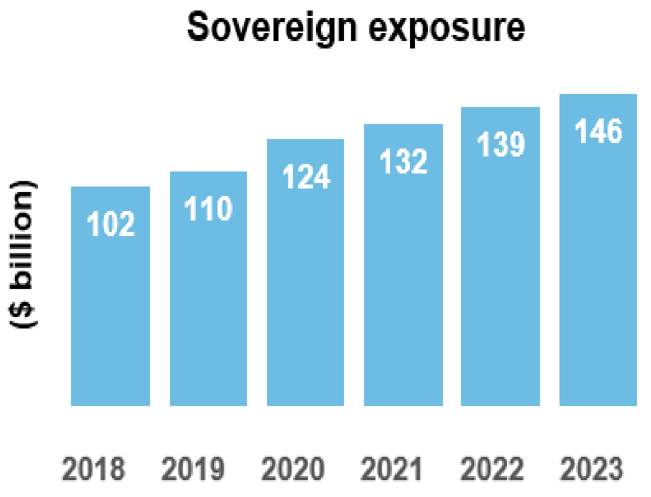
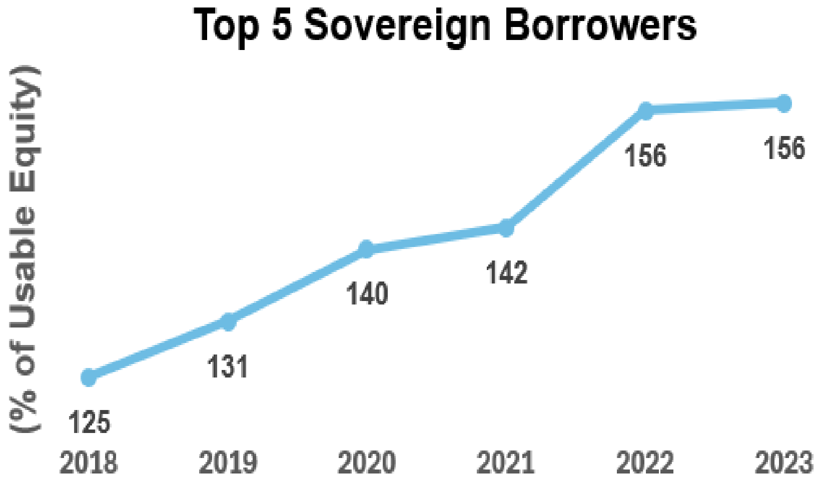
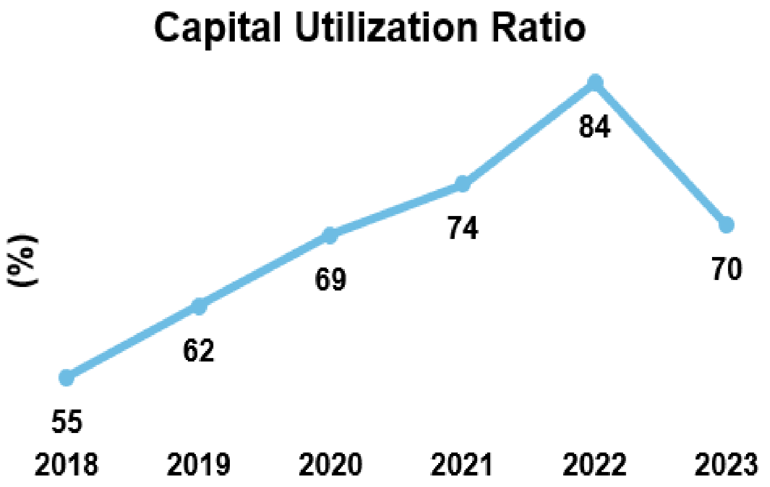
The Case for Exposure Limits: Exposure Growth

In the period since 2018, ADB's Operations portfolio has grown faster than its equity base. This trend is expected to continue over the medium term and will make ADB more sensitive to concentration risk.







	2018	2019	2020	2021	2022	2023	2024f	2025f	2026f	2027f
Operations portfolio growth rate (%)	6.0	7.6	13.4	5.1	4.8	4.2	4.6	4.3	5.8	4.8
Usable equity growth rate (%)	0.4	2.3	1.1	2.0	-2.1	3.8	1.1	2.2	1.7	1.7

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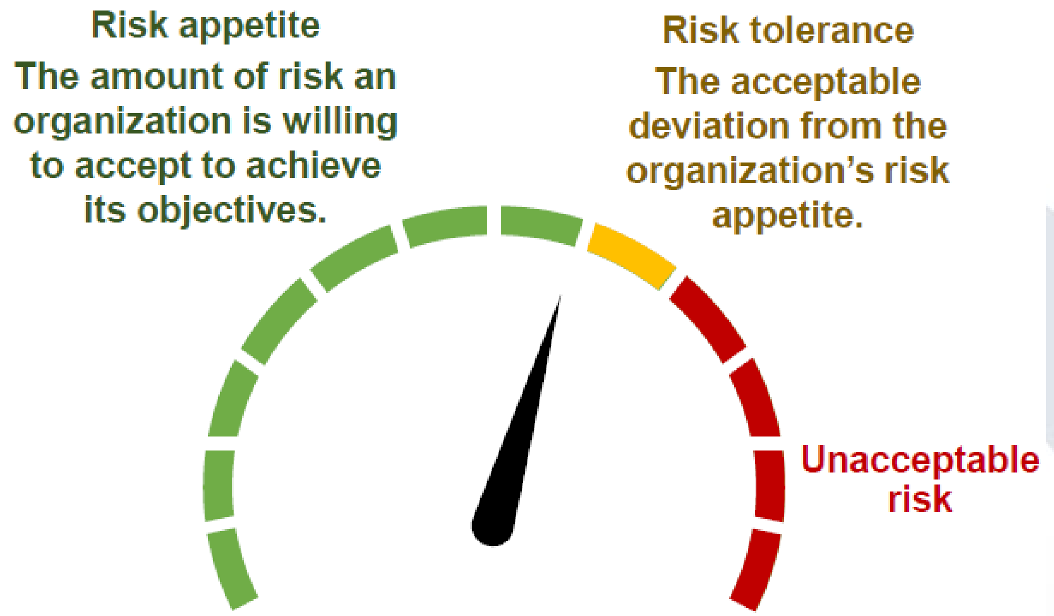
Note: f = forecast.

Guiding Principles: Appetite, Tolerance and Equitable Access

- **Risk Appetite** articulates the amount of exposure ADB is comfortable accepting in pursuit of its development objectives.

- **Risk Tolerance** is the maximum exposure ADB would be able to bear while protecting its capital and to ensure its continued viability as a lender.

- **Equitable Access to Financing** refers to ADB's ability to meet greater demand from countries with large economies without affecting its ability to meet demand from countries with smaller economies or less developed economies.



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Limit Framework: Country Concentration Limit

The country concentration limit is proposed to be defined as the lower of:

(i) a risk-based amount which is the aggregate of two limits, i.e., the SO and NSO limits. (Risk Tolerance)

(ii) 35% of the GDP of a country

Country concentration limit (SO+NSO) defined as the lower of (A) or (B)

(A) Sum of (C) and (D):
sovereign and nonsovereign risk-based limit

(C) Sovereign risk-based limit

risk tolerance in $ nominal terms

+

(D) Nonsovereign risk-based limit

risk tolerance in $ nominal terms

(B) Repayment Capacity

35% of a country's GDP in $ terms

Repayment Capacity

Limit is not applicable
for SIDS. Debt service capacity
Is ensured by an annually confirmed
Debt service sustainability analysis

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Limit Framework: Sovereign Limit

Risk category of the country (risk rating in ADB scale)	Risk appetite	Risk tolerance	
	% of usable equity	% of usable equity	$ billion
Low risk (1-5)	50.0%	55.0%	**$30.00**
Moderate risk (6-8)	40.0%	45.0%	**$24.50**
Significant risk (9-10)	30.0%	35.0%	**$19.00**
High risk (11-13)	25.0%	30.0%	**$16.00**

- ✓ Risk appetite decreases from 50% to 25% depending on perceived creditworthiness.
- ✓ Risk-based limits: sovereign limits will be defined in **nominal terms** for convenience and stability of the indicator.
- ✓ Nominal amounts are **free from short-term volatile impact** of various market factors affecting usable equity.

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Limit Framework: Nonsovereign Limit

The nonsovereign country limit is proposed to be defined as the lower of:

(i) 30% of total nonsovereign exposure;
(ii) 10% of its Gross Domestic Product (GDP) or $25 million, whichever is larger; and
(iii) a risk-based amount as per table below:

Risk category of the country (risk rating in ADB scale)	Risk tolerance	
	% of usable equity	$ billion
Low risk (1-5)	10.0%	**$5.00**
Moderate risk (6-8)	5.0%	**$2.50**
Significant risk (9-10)	3.0%	**$1.75**
High risk (11-13)	2.0%	**$1.00**

- ✓ Risk-based limits: Nonsovereign limits defined in **nominal terms** for convenience and stability of the indicator.
- ✓ Nominal amounts are **free from short-term volatile impact** of various market factors affecting usable equity.
- ✓ Proposed NSO country limits are increased compared to prevailing NSO limits, save for NSO 11 rated countries given the recalibration of risk categories.

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Limit Framework: Country Concentration Limit

Risk-based limits (simplified example)

(C) Sovereign limit (in $ terms) + **(D) Nonsovereign limit (in $ terms)** = **(A) Country concentration limit (SO+NSO in $ terms)**

Risk category of the country (risk rating in ADB scale)	Sovereign		Nonsovereign		Country total
	Risk tolerance		Risk tolerance		Risk tolerance
	% of usable equity	$ billion	% of usable equity	$ billion	$ billion
Low risk (1-5)	55.0%	**$30.00**	10.0%	**$5.00**	**$35.00**
Moderate risk (6-8)	45.0%	**$24.50**	5.0%	**$2.50**	**$27.00**
Significant risk (9-10)	35.0%	**$19.00**	3.0%	**$1.75**	**$20.75**
High risk (11-13)	30.0%	**$16.00**	2.0%	**$1.00**	**$17.00**

- ✓ Risk-based limits: country concentration limits defined in **nominal terms** for convenience and stability of the indicator.
- ✓ Nominal amounts are **free from short-term volatile impact** of various market factors affecting usable equity.

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Lending in Excess of Risk Appetite

- Lending may be pursued up to the level defined by risk appetite (green zone).
- Sovereign lending in excess of risk appetite but below risk tolerance may also be pursued, subject to:
    - A surcharge on *new* sovereign regular OCR loans leading to an excess of risk appetite. The surcharge proposed is 25 bps per percentage point in excess.
    - Standard eligibility criteria for concessional loans, for which no surcharge is applied.
- For the nonsovereign operations, only risk tolerance as defined by exposure limits are relevant.
- Lending above risk tolerance may not be pursued.

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