Financial Policies

1. Introduction
2. Principles of financial management
3. Capital, net income and reserves
4. Credit risk management
5. Assets and liabilities management (ALM)
6. Treasury operations
7. Pricing policy
8. Liquidity policy
9. Borrowing policy
10. Revenue recognition, restructuring and write-off policy
11. Corporate governance
1. INTRODUCTION

This document sets out the Financial Policies of the Black Sea Trade and Development Bank, defining the framework of the Bank's financial management and the policy guidelines.

Chapter 2 describes the financial framework in which the Bank pursues its Mandate and the principles that guide the Bank's financial management. It underpins the Bank’s commitment to financial viability by choosing a revenue-oriented approach for its operations, actively managing the inherent risks, as well as strict budgetary discipline and efficiency enhancement.

Chapter 3 deals with the Bank’s capital and limitations on the use of it. It describes the Bank’s approach to capital utilisation and portfolio turnover. The Bank’s capital is to be used for its ordinary operations in pursuit of its Mandate. Special Funds will be used, within the restrictions set by the rules and regulations agreed upon with the donor, in accordance with the purpose and the functions of the Bank.

Chapter 4 sets up the credit risk management policy.

Chapter 5 covers the Assets and Liabilities Management.

Chapter 6 discusses the Bank’s Treasury operations. The Bank engages in this activity for managing its liquid assets, mainly held in anticipation of operational\(^1\) disbursements, and for attracting supplementary external funding. The Bank’s Treasury activities are auxiliary to its core business. Although being a profit centre the Treasury will be appraised primarily on the execution of its main tasks, secondly on the profits it has generated. Special attention has been paid to the rules and limits set to its operations.

Chapter 7 covers Pricing Policy.

Chapter 8 covers the Bank’s liquidity policy. Liquidity is pre-conditional to any bank’s capacity to stay in business. Therefore the Bank is dedicated to always be in a position to meet its obligations and refrain from any unnecessary additional risks.

Chapter 9 sets the Guidelines for the Borrowing System.

The Bank’s policy on revenue recognition and write-offs is the subject of Chapter 10. The Bank aims to generate sufficient income in order to recover its operating costs and, above all, to build up reserves both as a buffer against the risks inherent in its operations and to allow for future growth of its portfolio. Net income earned is thus essential to build the Bank's reserves.

Chapter 11 covers issues of Corporate Governance.

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\(^{1}\) The Bank has 2 kinds of operations: the operations financed from its Ordinary Capital Resources - “ordinary operations” - and operations financed by Special Funds Resources - “special operations” (article 10 of the Establishment Agreement).
2. **PRINCIPLES OF FINANCIAL MANAGEMENT**


The Financial Policies build on the Agreement Establishing the Bank and provide the financial framework within which the Bank pursues its Mandate as stipulated in the Agreement.

Sound financial management is essential for the Bank to fulfil its Mandate in a financially viable way.

The Bank's financial management is based on the following principles:

- financial viability
- market and performance orientation
- comprehensive risk management
- transparency, accountability and effective corporate governance.

**Financial Viability**

The ultimate aim of the Bank's financial management is to establish and maintain financial viability. Financial viability ensures that the Bank can continue to implement its Mandate effectively without impairing its capital base. It also enables the Bank to move towards self-sufficiency in meeting the growing demand for its financing. It allows it to achieve and maintain a premier credit standing and thus complement its paid-in capital by borrowing funds in the capital markets on the best terms. It contributes to the success of the establishment of and subscriptions to Special Funds for special purposes.

**Market Orientation**

To support its objective of financial viability, the Bank is guided primarily by market practice in managing its day-to-day affairs and applies a conservative risk/return oriented approach to Treasury Operations. Although the Bank does not intend to maximise profits in the course of its activities, the Bank seeks at least to recover its operating and administrative costs and the cost of capital employed.

Market pricing is of critical importance to the fulfilment of the Bank's Mandate and underpins the Bank's policy principle of additionality. Market pricing is also important for attracting other investors in the co-financing of projects and thus, in general, for the mobilisation of external funds.

The Bank's revenue orientation is also reflected in its Treasury management. The Bank's liquid assets and liabilities will be managed in conformity with the Bank's policy guidelines. Within this framework the Treasury will apply the best available knowledge and techniques for reconciling the Bank's need for generating revenues with the necessity not to incur unnecessary risks and costs. Benchmarks are to be established with respect to both the investment return on its liquid assets and the cost effectiveness of its borrowing program.
The Bank will measure the performance of its activities and asset categories by using a management accounting system that allows for attributing to each activity and asset class the revenues it has generated and the direct costs incurred by it, including the provisions that had to be made for specific nonperforming assets.

The Bank pursues its operational Mandate with strict budgetary discipline, ensuring that its limited resources are utilised efficiently. As a corollary of strict budgetary discipline, the Bank continuously strives for productivity enhancement. To support productivity enhancement, performance and profitability measurements are applied in the preparation of medium-term business plans and annual budgets, complementing each other in an integrated business planning, linking allocated resources with performance objectives.

**Comprehensive Risk Management**

The Bank is committed to actively identify and manage all risks inherent in its activities in order to support its sustainable profitability objective and safeguard its capital base. The Bank pays particular attention to managing credit risks in the course of its core activities and treasury operations, market risks in its Treasury as well as compliance and operational risks in its organisation and activities.

By virtue of its Mandate, the credit risks inherent in the Bank's ordinary operations are relatively high, due to the geographic concentration of its operational portfolio and the nature of the Bank's involvement in the projects it undertakes in conformity with article 2 of the Establishment Agreement. The application of sound banking principles in the Bank's credit process seeks to ensure that these significant credit risks are properly identified, measured and managed while other risks resulting from its ordinary operations should be mitigated to the extent possible.

Since the Bank's ordinary operations are inherently relatively risky, the management of Treasury activities is more conservative. A comprehensive risk management framework for Treasury activities, particularly addressing credit and market risk, is to be established. Risks in other assets are mitigated on a pro-active basis; any soft element in such assets should be provisioned against appropriately. Deteriorating assets will be handled in accordance with the Bank’s remedial policies.

Compliance risk management relates to the systems, processes and controls established in order to anticipate, prevent and mitigate the potential risk of financial loss, legal sanctions or loss to reputation BSTDB may suffer as a result of its failure to comply with: (i) all applicable laws, Bank’s regulations, rules and procedures; (ii) codes of conduct; and (iii) standards of good practice. To this end the compliance risk management function will independently identify, assess, monitor, advise and report on the Bank’s compliance risk.

Operational risk management encompasses identification, assessment, monitoring and mitigation/control of the operational risk inherent in all material products, activities, processes and systems. In the context of the Bank activities operational risk refers to the risk of loss resulting from internal events such as inadequate or erroneous human action, failed internal processes and systems, or from external
financial policies of the bank

applicable organizational structure, policies and procedures shall be established to address all aspects of operational risk to which the bank is exposed.

the bank's risk management framework will evolve as the bank continues to apply industry best practice in the measurement and management of risks.

transparency, accountability and effective corporate governance

the bank is committed to corporate governance at the highest level to ensure transparency, accountability and adequate checks and balances on the bank's activities. the key component of effective governance is a clear definition and delineation of responsibilities among the board of governors, the board of directors and management, as well as targeted reporting with a view to ensure appropriate execution of separate responsibilities. the governance structure is supported by comprehensive internal and external auditing as well as appropriate financial and management information reporting.

3. capital, net income, and reserves

this chapter deals with the bank's (i) capital and the statutory limitations on its use; (ii) ordinary operations and the various instruments offered; and (iii) capital utilisation and portfolio turnover policies.

3.1 the bank’s authorised capital stock

article 8 of the agreement recognises as ordinary capital resources:

- the authorised capital stock of the bank
- funds raised by borrowings
- funds received in the repayment of loans or guarantees
- proceeds from the disposal of equity investments
- income derived from loans and equity investment made from the bank’s own and borrowed funds, guarantees and underwriting
- any other funds or income.

as specified in article 4 of the agreement establishing the bank, the bank's initial authorised capital stock is sdr 1 billion. the initial capital stock had been fully subscribed and allocated, and the paid-in portion of capital was fully contributed by shareholders.

the authorized capital of the bank has been increased to sdr 3 billion, of which the subscribed capital was increased to sdr 2 billion. the additional sdr 1 billion of subscribed capital was fully allocated to founding member states. the unallocated capital of sdr 1 billion remains available for further subscription and/or allocation.

the capital of the bank is divided into:

30% paid-in shares
70% unpaid, but callable shares
The aggregate par value of the authorised and subscribed paid-in shares is SDR 600 million.

The Board of Governors is obligated to review the capital stock of the Bank at regular intervals, which are not to exceed 5 years.

3.2 Limitations on the Use of the Bank’s Capital

The BSTDB Establishing Agreement places a number of institutional limitations on the use of the Bank's capital for its ordinary operations. Treasury investments, i.e. management of the Bank’s liquid assets, important as they are in any banking operation, for purpose of revenue generation are considered auxiliary to the Bank's ordinary operations. The Bank does not consider them to be a fully independent operation within the Bank. Consequently the Bank will not generally allocate a separate budget to Treasury investments.

Article 15 of the Agreement contains a provision to the effect that the total amount of outstanding loans, equity investments and guarantees made by the Bank in its ordinary operations shall not at any time exceed 150% of the total of the Bank's unimpaired subscribed capital, reserves and surpluses included in its Ordinary Capital Resources, establishing a 1.5:1 gearing ratio. In calculating the actual gearing ratio the Bank sets-off the total of disbursements - net of cumulative repayments - and firm commitments outstanding against the actual amount of the Bank's unimpaired subscribed capital, reserves and surpluses. The ratio thus calculated should not exceed the limit of 1.5:1. The policies with regard to the gearing ratio are detailed in the Portfolio Risk Management and Investment Policies.

Within this ratio Article 15 of the Agreement stipulates, that the amount of the Bank’s disbursed equity investments shall not at any time exceed an amount corresponding to its total unimpaired paid-in subscribed capital, surpluses and general reserve. The ratio thus calculated shall not exceed a limit of 1:1.

The 1.5:1 gearing ratio is a cornerstone for the Bank's financial soundness. It is especially important as the Bank is exposed to more as well as higher than average risks as it undertakes activities with a higher risk profile, in an economically rapidly evolving region, invests in enterprises in a volatile business environment and faces the risk that its customers operate in currencies not traded internationally.

Rating Agencies acknowledge a sound-gearing ratio as one of the essentials of any Bank's prudent financial management. A good credit rating is conditional for the Bank’s ability to fund its lending and investment activities by placing debt instruments in the capital markets, for being eligible as counterparty in Money Market and Foreign Exchange operations, and as member of a syndicate.

3.3 Capital Utilisation

The Bank is committed to an efficient use of its capital resources. A capital utilisation policy will enable the Bank to maximise the use of capital resources within the limits of its statutory gearing ratio.
A capital utilisation policy has been adopted that aims at maximising the return on capital by optimising the allocation of funds to different asset classes without neglecting the Bank’s functions as stated in Article 2 of the Agreement. The Bank’s Assets & Liabilities Committee will regularly review this policy.

The Bank has adopted the Headroom concept as a tool for implementing and managing the allocation of funds.

**Headroom**

Headroom is defined as the difference between the statutory limit on the Bank's ordinary operations as per Article 15 of the Agreement (see Section 3.2) and the total amount of (net) disbursed and committed loans, equity investments and issued guarantees in the Bank's portfolio. Headroom is thus a measure of the level of additional funds the Bank can commit before it reaches its statutory limit.

The factors that affect the upper limit on the Bank’s headroom include:

(i) *changes to reserves and surpluses:* Any change to accumulated reserves and surpluses impacts the total amount of commitments that the Bank may enter into. As the Bank moves towards sustainable profitability, its retained earnings will enable it to grow its capital base (of paid-in capital, surpluses and reserves) and thus generate enough headroom to autonomously fund the expansion of its operations.

(ii) *turnover of the loan and equity portfolio:* repayments on loans, equity disposals and other contributions to portfolio turnover generate additional headroom for the Bank as well, as the Bank's operational portfolio matures and the Bank’s activities diversify.

(iii) *currency rate fluctuations:* re- and de-valuations of the currency of denomination of the Bank’s commitments vis-à-vis its unit of account also affect the level of headroom available to the Bank.

**Capital Utilisation Framework**

In order to assess the effective utilisation of capital in the Bank’s operations within the limits of the statutory gearing ratio, the Bank will assess its capital utilisation on a risk-weighted basis. This approach builds on current Banking practice which links risk assessment of operations, based on credit ratings, with pricing and provisioning.

This capital utilisation framework is not intended to guide the selection of projects. This selection process is based on the basic principles of sound banking, additionality and economic cooperation. Development impact, in particular, tends to preclude a preferential allocation of funds towards projects with the best risk/return ratio. A framework which considers the risk assessment, pricing and provisioning of projects and their interrelationship as related to capital can be an important tool in monitoring capital usage.
Portfolio Turnover

The Bank's portfolios are expected to turn over naturally as instalments are paid on the Bank's loans and/or equity investments are sold to corporate or private investors. Active pursuit of portfolio turnover entails a multi-faceted approach:

- **reduction of idle commitments**: The Bank continuously scrutinises its outstanding commitments in order to eliminate any idle commitments. The capital tied-up in such commitments could more efficiently be allocated to other promising operations.

- **increased raising of external funding**: The Bank places a high priority on raising external capital for the funding of its projects. The greater the success of external fundraising, the higher the number of operations the Bank will be able to finance given its capital base. The Bank will create a base of potential co-financiers in order to effectively putting together syndicates for financing big capital expenditures of its customers.

In developing initiatives to revolve its portfolio, the Bank will carefully consider the effect on:

- **the Bank's impact on the operation**: The Bank should ensure that its role has been essentially completed. The Bank should not sell an investment\(^2\) if co-financiers still perceive its role as actively engaged investor to be vital. Similarly, the Bank should refrain from exiting investments which still require an active involvement by the Bank in its corporate governance. Finally, the Bank should also be sensitive to (negative) reactions from customers and markets to any disposal of its investments.

- **the Bank's portfolio**: The Bank should assess the impact of the sale of its assets on the risk profile of the remaining operational portfolio. Any sale of one of the Bank's most creditworthy investments may result in a deterioration of the quality of the Bank's portfolio if the proceeds cannot be re-invested into assets with equivalent risk.

- **the Bank's net income**: The Bank should assess the impact of any asset sales on its net earnings. The proceeds from the sale of relatively high-earning operational assets will temporarily be invested in relatively low-earning liquid assets. The differential return between operational and liquid assets could result in lower income in the short term until the liquid assets are re-deployed into operational assets, which could potentially generate a lower return for the Bank than the original investments as well. Although profit maximisation is not to govern the Bank's decision to sell-off its investments, the Bank should carefully consider the impact of portfolio turnover initiatives on its net earnings.

- **the Bank's preferred creditor status**: The Bank should structure portfolio turnover initiatives so as to minimise the risk that any preferred creditor status of its loans be subjected to scrutiny.

\(^2\) By investment is to be understood in this paragraph: equities and loans.
3.4 Net Income

This chapter elaborates on these issues and also addresses specific policies on revenue recognition and provisioning, as well as related policies on loan rescheduling and write-offs.

The Bank aims to generate sufficient income in order to recover its operating costs and to build up reserves both as a buffer against the risks inherent in its operations and to allow for future growth of its portfolio. Net income earned is thus essential to build the Bank's reserves. In support of this objective, the Bank is committed to strict budgetary discipline and productivity enhancement.

Article 8 of the Agreement determines that the operations of the Bank shall consist of ordinary operations financed from the Ordinary Capital Resources and special operations financed by the Special Funds Resources as referred to by article 17 of the Agreement. The two types of Resources will be kept strictly separated. The financial statements of the Bank shall show the reserves of the Bank arising from its ordinary operations. Separate financial statements will be issued for each special operation as per the Agreement Establishing the Bank.

Income Recognition

The Bank records interest and fees as income on an accrual basis. Accruals on loans and credits of which the payments of interest, fees and/or instalments is overdue for more than 90 days, will not be recognised as income. Any interest accrued on a loan or credit that has been placed in non-accrual status, will be reversed out of current income.

Income from Treasury operations will be recognised depending on the kind of activity and the kind of security:

- fixed income securities: interest on an accrual basis, gain on the sale of the securities;
- currency transactions: realised margin between buy and sale;
- derivatives transactions: premiums earned / paid, gain on the sale of the derivatives.

Cost Recognition

The Bank records current operating costs and funding costs on an accrual basis. Other costs and expenses are recorded when invoiced or declared to the Bank. Extraordinary costs and expenses are entered into the Bank’s accounts when they occur. Expenses appertaining directly to ordinary operations shall be charged to Ordinary Capital Resources of the Bank. Expenses appertaining directly to special operations shall be charged to Special Funds Resources. Any other expenses shall, subject to paragraph 1 of Article 16 of the Agreement, be charged as the Bank shall determine.

Movements in the Bank’s provisions are recognised as losses or gains as soon as actual developments in the portfolio justify an addition or a withdrawal from these provisions.
Delinquency

The Bank maintains the following policies and measures with respect to any delinquency in payment of charges, commissions, fees, interest or principal on its loans to the public or private sectors. These will be incorporated in loans or investment agreements as appropriate. Loan agreements may specify conditions for default that may trigger reparatory and remedial actions more stringent than the ones described hereafter. The time limits triggering specific actions should not be greater than the ones specified in this document.

- When payments of interest and principal are overdue for more than 30 days, the Bank will suspend any disbursements under current agreements to the borrower or the entity controlling the borrower, and not enter into new engagements.

- After 60 days the Bank will have the right to stop accruing interest and charges on the loan, and will consider appropriateness for application of penalties. The management of the loans et cetera to the borrower will be transferred to a specialized team within the Bank coordinated by the Project Implementation and Monitoring Department. This team will reconsider the Bank’s position with the borrower, analyse the financial and economic condition of the borrower and its forecasts, and - when taking into account the Bank’s policy guidelines on this matter\(^3\) - consider if a re-scheduling of the loan, a restructuring or other measures aimed at improving the chances of recovery are indicated. The possibility of a work-out solution is contemplated and the Bank establishes a working relation with the client on this basis.

- After 90 days, if no solution is found and there is no agreement for working out a solution, any accrued but unpaid interest, charges and penalties on the loan will be reversed against current income, and default is declared. The interest, charges and penalties accrued are to be moved to an off balance sheet Memorandum account where they will be held until recovery or write-off of the asset. The loan shall be placed on a non-accrual basis and classified as non-performing. The Bank will consider if a write-off against provisions is appropriate, and decide if it will take measures for safeguarding the collection of the loan, and/or exercise the security, in conformity with its policies on that matter.

3.5 Reserves and Surpluses

Reserves

Reserves represent the internal generation of capital through retention of earnings. These are free and unencumbered by any specific claims to qualify as shareholder funds, and thus supplementing the share capital. Reserves are a component of primary (first tier) capital\(^4\). Reserves are the ultimate protection of the Bank’s capital against impairment resulting from credit risk losses in excess of provisions or losses due to market, operational and compliance risks.

\(^3\) See paragraph 5.2
\(^4\) Reserves are shareholder funds and should not primarily be looked upon as available for covering losses. They are only in last resort to be used as a buffer against losses.
The Bank targets a level of profitability guided by the desire to build an appropriate cushion of reserves against the risks inherent to its normal operations and subsequently to grow its capital base consistent with the Bank’s financial and growth objectives.

Article 36 of the Agreement attributes to the Board of Governors the powers to annually determine what part of the net income or surplus from ordinary capital operations shall be allocated to reserves. No income shall be distributed to Members until the reserves of the Bank shall have attained the level of 10% of the authorized capital, including all paid, unpaid but payable, and unpaid but callable capital (reference to Art 36 of the Agreement Establishing the BSTDB).

In addition to building up a cushion of reserves, retained income will enable the Bank to maintain the real value of its capital funds and increase its investment headroom through internally generated funds. Therefore, once the Bank has accumulated the minimum target of reserves, profitability margin target will be considered in light of the desired real growth in the volume of its operations, net of any re-flows from the turnover of the portfolio.

**Surpluses**

Surpluses are retained earnings, non-distributed to shareholders or allocated for specific purposes, that remain at the disposal of the Bank to supplement the share capital. Surpluses may start to be accumulated once the reserves reach the statutory level of 10% of authorized capital.

**4. CREDIT RISK MANAGEMENT**

This chapter deals with management of credit risks. Market risks are dealt in Chapter 5 Asset and Liability Management. Operational risks are described in Chapter 11 Corporate Governance.

The Bank is exposed to credit risk in both its ordinary operations and its Treasury activities. Credit risk arises since Treasury counterparties could default on their contractual obligations or the value of the Bank’s investments in debt securities could be impaired. The majority of credit risk is in the operations portfolio. The Bank will manage all aspects of its credit risk exposure within a robust credit management framework.

All of the credit risk management framework components inter-relate with one or more of the other components. These interrelationships are addressed in the Operations Cycle and Portfolio Risk Management and Investment Policies documents with respect to banking operations, and in the Treasury Policies document with respect to treasury activities, and appropriately detailed in internally approved documents. Bank Management is responsible for installing and maintaining all framework components – with four principal areas of focus:
Within and in support of this credit risk management framework, BSTDB develops further policy and operational documents to cover the following:

- **Establish a full set of operational portfolio management parameters** (limits, targets, guidelines) to control the Bank’s exposures with respect to:
  - Country
  - Single obligor
  - Single Project
  - Aggregate of largest five exposures

Portfolio parameters for collateral type may be established as the Bank acquires experience in its markets of operation.

- **Establish exposure guidelines** that specify:
  - The kinds of credit risks that the Bank will take
  - Target market guidelines
  - Risk asset acceptance criteria

- **Implement a robust operation analysis process** that specifies:
  - Financing criteria across which individual obligors/potential obligors are measured (credit quality factors)
  - Due diligence
  - Evaluation standards for each financing criteria
How to structure an operation
Contents of an acceptable financing approval package
Indicators for early detection of problems
Relationship profitability/performance targets

**Establish an operation approval process** that sets limits/guidelines for:

- Approval of new operations
- Rollovers of existing facilities
- Risk classification of operations
- Approval of remedial strategies
- Approval of restructuring/rescheduling plans

**Establish guidelines for operational portfolio provisioning** with respect to:

- Specific provisions
- General provisioning for portfolio level risks
- Write off standards and procedures

**Specify standards of operations administration** to include:

- Operations booking procedures
- Accounting standards
- Documentation standards
- Operational reporting standards

**Implement a risk asset rating system** that:

- Assigns risk ratings based on specified quantitative and qualitative assessments
- Is tightly linked to other credit risk management processes (e.g., approval, workout, audit, monitoring)
- Triggers specific actions at specific risk rating levels

**Establish a portfolio monitoring process** that specifies:

- Risk assets review frequency (by risk rating)
- Risk assets review standards (by risk rating)
- Collateral valuation requirements
- Early warning signals for asset quality deterioration
- Account profitability/performance review standards

**Establish a pro-active and robust process for managing nonperforming assets**, to include:

- A portfolio analysis process
- Designing and implementing remedial strategies/action plans
- Monitoring standards
- Collateral handling processes
- Restructuring/rescheduling guidelines
♦ **Put a robust MIS in place** at:

◊ Portfolio level
◊ Borrower group level
◊ Individual obligor level

♦ **Put in place a strong audit process** with the capabilities to:

◊ Independently evaluate asset quality and risk classifications
◊ Assess performance against and adherence to established policies, Processes, limits, targets and guidelines

**Portfolio Diversification**

The Bank seeks to maintain reasonable diversification in its credit portfolio to spread project and borrower credit risk. The Bank’s policy with respect to diversify credit risk in its ordinary operations aims at:

- Limiting country exposure
- Limiting project and borrower exposure
- Mitigating credit risks through security or other forms of risk-sharing

The Bank will diversify its operational portfolio across its countries of operations so that there is no excessive concentration of country exposure. Monitoring country exposure, evaluating country risk and using individual country credit review trigger limits are important elements of the Bank’s portfolio risk management. Methods applied in risk evaluation and risk assets review triggers will be set up in greater detail in other documents.

The Bank will also diversify its operational portfolio by setting exposure limits on the financing to single projects and to single obligors.

The Bank will periodically review its risk diversification guidelines and exposure limits to reflect the evolving nature of its operations and the changing types of risks they entail.

**Risk Mitigation**

The Bank will normally require its operations to benefit from some form of security or risk-sharing in order to mitigate the credit risks involved. When the Bank lends to non-sovereign public or private sector borrowers, it will normally require certain guarantees and, in all cases, will ensure that the parties involved share risks in a reasonable manner.

When the Bank is considering a financing application, it will negotiate covenants and conditions which ensure that all parties perform and that risks are reasonably distributed. All covenants and conditions such as negative pledge clause, mortgages, pledges on movables or current assets, or agreements sharing the security among the co-lenders etc., must be specifically adapted to each operation;
Organisational Responsibility

The **Credit Committee** is comprised of the following members:

- President
- Vice Presidents

Taking decisions by consensus, and 2 members:

- Secretary General
- General Counsel,

Taking part in the works of the Committee.

This composition of the Credit Committee will be reviewed by the Board of Directors periodically, but not less frequent than every four years.

The Credit Committee is the Bank’s management level decision making body with respect to financing matters. Key responsibilities include:

- Considering for approval trade, corporate and project related financing applications and rollovers
- Approving remedial management strategies, restructurings and reschedulings for problem operations

The **Risk Management Department** within the Finance Division has specific responsibility for:

- Making their own assessments of the nature and extent of the Bank’s credit risk exposure
- Tracking the Bank’s exposures vs. Management Committee/Board specified policies, limits and guidelines
- Reporting deviations from strategic/tactical limits, targets and guidelines to Banking Division management and the Management Committee
- Providing regular analytical support to the Bank’s strategic (Management Committee/Board) and tactical (Banking Division management) decision makers
- Making specific recommendations to the Credit Committee on changes to credit risk management parameters

The Operations Cycle Policy document describes in detail the operational aspects of responsibilities related to origination, preparation, analysis, administration, supervision, monitoring, and workout.
5. **ASSETS AND LIABILITIES MANAGEMENT (ALM)**

The Bank is exposed to a range of market risks associated with both its on and off-balance sheet activities. In the course of its operations, the Bank will be exposed to foreign exchange risk, liquidity risk, interest rate risk, credit risk, and other market risks, on a regular basis.

The objectives of ALM are: (i) to safeguard the Bank’s capital; (ii) to ensure that market risks are managed effectively and not allowed to negatively impact the Bank’s ability to meet its financial obligations promptly; (iii) to improve the Bank’s earnings potential; and (iv) to create a framework for flexible-funding activity. Consequently, the Bank’s management is expected to actively manage the Bank’s market risks in accordance with a robust ALM system. Assumption and management of credit risk on financing activities is inherent to both the Bank’s stated purpose and execution of its mission and is explained in detail in chapter 4 – Credit Risk Management.

The Bank is committed to adopting and maintaining best industry practice in measuring and managing risks. One other feature of the Banks’ assets and liabilities management is its determination to keeping the measuring and reporting of risks strictly separate from the management of those risks.

**Implementing this system, Bank management makes sure that:**

1) All relevant data are available,

2) Organisational units exist with specific responsibilities for:
   - Making ALM decisions at strategic, tactical, and operational level (e.g. Assets & Liabilities Committee, Treasury)
   - Providing ALM decision makers with the MIS\(^5\) required for informed decision making (e.g. Risk Management Unit and result monitoring)
   - Executing ALM processes on a day to day basis (e.g. Treasury)

3) Managers and analysts have the skills needed for successful ALM decision-making and execution.

4) A robust MIS capability is in place that quantifies ALM exposures and facilitates risk monitoring and effective ALM decision making at strategic, tactical, and operational levels.

5) Clearly articulated risk parameters are established within which all ALM activities must take place with respect to management of the Bank’s foreign exchange risk, liquidity risk, interest rate risk, other market risks, credit risk.\(^6\)

6) A set of robust processes is developed and implemented for managing these four ALM risk areas within established risk parameters.

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\(^5\) Management Information System  
\(^6\) Credit risk assumed in Treasury Operations
5.1 The Bank’s Approach to ALM Risk Management

The Bank’s approach to assuming and managing ALM risks is very conservative - with an emphasis on risk mitigation and balance sheet immunisation. While specific ALM risk management strategies and acceptable risk parameters are promulgated by the Assets and Liabilities Management Committee (ALCO), ALCO decision making is guided by the following fundamental policies in each of the risk areas:

1) Foreign Exchange Risk: As a matter of policy, the bank will strive to maintain a neutral foreign exchange position and the ALCO’s foreign exchange risk management parameters must reflect this. The guiding principles will be as follows:

- The Bank’s open position will be monitored daily by the ALM unit.
- The Bank will not take significant discretionary (own account) foreign exchange position.
- The costs associated with hedging activities will, in principle, be borne by the borrowers whose loan currency requirements necessitate hedging.
- It is understood that the Bank’s equity investment portfolio may involve exchange risks in member country currencies that may occasionally not be hedgeable at reasonable cost; however, these exposures will be closely monitored and hedged when cost-effective vehicles are available.

2) Liquidity Risk; outlined in Chapter 8 of these Financial Policies and discussed in detail in the Treasury Policies

3) Interest Rate Risk: As a matter of policy, the Bank will strive to immunise its balance sheet to the extent feasible from the effects of interest rate movements and Assets & Liabilities Committee’s interest rate risk management parameters must reflect this. The cornerstones of the Bank’s interest rate policy will be as follows:

- The Bank’s interest rate exposure will be monitored weekly by the ALM unit of the Finance division.
- The Bank will not take significant discretionary (own account) interest rate positions.
- The costs associated with hedging activities will, in principle, be borne by borrowers whose interest rate bases requirements necessitate hedging.

4) Credit Risk on Treasury Operations: assumption of credit risk within the Treasury will generally be kept to a minimum and restricted to counterparties and investments, as determined at the appropriate level of decision making. The Treasury may establish credit lines for reciprocal FX and money market activities with Member State financial institutions. The methodology for establishing credit exposure limits will be determined by ALCO and implemented and monitored by the Risk Management Department.

5) Other Market Risks: Certain investments made by the Bank (e.g. equity investments) may not be hedgeable. However, the aggregate exposures associated with these investments must be accurately monitored and appropriately valued when risks are incurred on behalf of customers (e.g.
commodity price hedges). The product must be priced in a way that reflects those risks and the bank’s associated hedging costs.

5.2 Management and Measurement of ALM Risks

ALCO will be responsible for setting strategic direction in ALM risk management and will establish a specific numerical limits, targets, and guidelines within which tactical. And operational ALM decision-making must take place. ALCO consists of the following permanent members:

- President
- Vice Presidents

Treasury is the only Bank unit that may incur market risks and is responsible for ensuring that these risks are actively managed by the ALM unit. Eligible instruments for the management of market risks include both cash instrument and over the counter as well as exchange-traded derivatives as further specified in the Treasury Policies (approved by the BoD). The management of market risks with regard to principles, parameters, credit risk constraints, and interest rate constraints and Treasury risk management practices is also specified in the Treasury Policies.

All foreign exchange and interest rate exposures are quantified on a regular basis. Specific and aggregate risk measurements are provided on a regular basis as well. In measuring market risks, the Bank employs the best industry standards, including a mark to market policy for appropriate assets and liabilities. Note

5.3 ALM and Analytical Support

The ALM Unit of the Treasury Department within the Finance Division is assigned specific responsibility for:

- Structuring BSTDB’s assets and liabilities to match the Bank’s exposures in terms of maturity, currency and interest rates
- Making their own assessments of the nature of the Bank’s risk exposure in the five key ALM risk areas
- Tracking the Bank's exposures vs. specified policies, limits, targets and guidelines
- Reporting deviations from strategic/tactical limits, targets and guidelines to appropriate levels of Treasury, Management and ALCO
- Providing regular analytical support to the Bank’s strategic (ALCO) and tactical (Treasury) ALM decision makers (e.g., monthly ALCO/Treasury reports packages)
- Maintaining and operating the Bank’s ALM analytical software (e.g., Duration, Value at Risk)
- Making specific recommendations to ALCO/Treasury position managers on changes to ALM strategies and tactics
- Undertaking special ALM studies/projects at the request of ALCO and Treasury management
- Ensuring that decisions taken by ALCO are promptly communicated throughout the Bank
- Coordination of the Bank’s ALM strategy, implementation of ALCO’s guidelines, and monitoring compliance.
6. TREASURY OPERATIONS

Treasury conducts its activities within a comprehensive framework provided by the BoD approved Financial Policies and Treasury Policies. The setting-up of the control system for the Treasury is the responsibility of the Bank’s management.

The Treasury is guided by the principles of transparency, accountability and profitability within conservative risk parameters.

The Treasury Policies determine at a sufficiently detailed level the role and functions of the Treasury department, and establish the liquidity, borrowing and investment policies, while also setting-up a comprehensive financial risk management framework.

7. PRICING POLICY

The Bank seeks to recover all costs of intermediation (including administrative expenses, borrowing costs and provisions against expected losses) and to earn an appropriate return on the Bank’s capital. The pricing of products of all types will be in line with the pricing of assets with similar risk profiles by other financial institutions and thus (to the extent such comparisons can be made and/or a market exists) reflects the market's perception of the risks involved.

Pricing Principles

In its pricing policy, the Bank charges a margin over the base rate plus fees and commissions to recover the administrative and operating cost incurred in generating, implementing and monitoring a loan as well as the cost of capital employed. Pricing will to the extent possible also reflect the underlying credit risks of the Bank’s operations. The cost of capital employed takes into account both the actual cost of borrowed funds and an appropriate opportunity cost for paid in capital. In general, pricing should result in an appropriate return on paid in capital and be also sufficient to build up a cushion of reserves and provisions against potential capital impairment, enable the Bank to maintain the real value of its capital and increase its investment headroom through internally generated funds.

The Bank’s pricing policy is based on the Articles of Agreement Establishing the Bank and is elaborated further in Portfolio Risk Management and Investment Policies.

♦ Basic principle: The Bank’s pricing policy reflects the fundamental principles of market pricing and recovery of operating and capital costs associated with transactions.

♦ Pricing components: These components include the base rate, margin, commissions and fees.

♦ Pricing is structured flexibly bearing in mind the different characteristics of individual transactions. Specifically, in the context of market pricing and recovery
of operating and capital costs, the Bank typically considers the following factors in determining margins and fees (not necessarily in order of importance):

- Market pricing
- Cost of funds
- Compensation for credit risk
- Collateral and other security
- Charge for undisbursed funds
- Administrative cost
- Return on capital.

**Base Interest Rates**

The base interest rate is linked to Libor, or equivalent benchmark for actively traded currencies, if appropriate.

**Pricing Margins**

The risk margin represents a spread over a base rate. A range of risk factors guides pricing of margins:

- Transaction specific risks are based on an assessment of risk factors affecting an obligor’s commercial viability and the availability of collateral or other security. Pricing of these risks is normally set on the basis of the best estimate of the average risk during the life of the operation. As part of standard practice, important points which arise relating to a loan’s risk profile will be highlighted in loan documentation.

- Country specific risks are based on the potential impact on probability of default of economic developments. The Bank distinguishes differences in country risk by using economic risk indicators based on credit assessment consistent with those of several leading external sources.

- The Bank utilises a risk rating system to signify the relative credit quality of the Bank’s assets. The risk rating is the main determinant for the classification of loans, and thus the aggregate quality of the Bank’s operational portfolio may have correspondence in pricing individual operations.

- In addition to country and project risk, several other factors may be reflected in the margin, such as an adequate allowance for covering administrative cost, cost of funds, return on capital, etc.

**Commissions and Fees**

Fees and commissions are separate components, which include front-end commissions, commitment charges and other fees. These commissions and charges may fluctuate within a range and vary on a case-by-case basis.
Delegation of Pricing and Reporting to Board

The Board of Directors establishes the principles of the Bank’s pricing. The application of this policy in the case of individual projects is delegated to management in order to give the Bank adequate flexibility in pricing negotiations. The Board's supervisory and control function with respect to pricing is exercised through reviews. Pricing information of specific loan transactions is not disclosed but is available to the parties involved in such transactions. General aggregate pricing information on loans is provided to the Board of Directors periodically.

8. LIQUIDITY POLICY

Liquidity is the cornerstone for any banking business. It provides assurance to depositors, stakeholders and shareholders that the Bank is in a position to meeting its financial obligations and hence will not need to cease operations and call its callable capital. These obligations include debt service, disbursements on loans and equity investments, calls on guarantees and unanticipated expenses. This assurance is all the more important given the risks the Bank runs in its ordinary operations. In a major crisis, such as a systemic default, the Bank will need to rely on an adequate level of liquidity to offset any cash shortfall that could impair its ability to service its debts and meet its other financial obligations.

The liquidity policy of the Bank aims at balancing the term structure of the Banks’ financial assets and liabilities in such a way that it allows for a smoothly running of its business.

The Liquidity Risk Management Policy is a constituent part of the Treasury Policies.

9. BORROWING

The Bank will build-up its borrowing capacity through establishing dialogue with rating agencies, developing its profile, maintaining its presence in the financial markets and tapping funds on appropriate terms whenever such funds are available and needed for the operations of the Bank. The Bank is authorised to borrow on international and local markets according to applicable legislation in the country concerned.

On an ongoing basis, the key imperative for the Bank’s borrowing policy is to maintain strong liquidity while cost effectively providing the long term funds needed to meet operational requirements.

The President will present when necessary to the Board of Directors a Borrowing Program for consideration and approval. The level of borrowings will be determined in light of the Bank’s operational requirements and the Bank’s liquidity policy.
The Bank’s borrowing program also has four important objectives:

- Augment, prudently, the Bank’s capital resources to further support its objectives of making loans and investments to support trade and development of member countries.
- Facilitate effective liquidity risk management by seeking close final maturity matching of the Bank’s assets and liabilities.
- Facilitate currency risk management by seeking to match, on-balance-sheet, the aggregate currencies of the Bank’s assets and liabilities.
- Facilitate interest rate risk management by seeking to match, on-balance-sheet, the interest rate maturities of the Bank’s assets and liabilities.

The Bank will pursue its borrowing program with specific emphasis on:

- Building and safeguarding the Bank’s reputation as a premier borrower;
- Conducting the program within a multi-year horizon;
- Diversifying the Bank’s funding sources;
- Seeking to achieve maximum flexibility by gaining access to a broad range of currencies, markets and maturities;
- Actually diversify in a wide range of currencies, maturities, instruments and structures;
- Seeking to obtain average maturities in its liabilities to match the average asset maturity;
- Offering its securities through public bond issues and private placements;
- Selecting borrowing techniques and instruments that will match asset preference of investors.

The Borrowing Policy is a constituent part of the Treasury Policies.

10. REVENUE RECOGNITION, RESTRUCTURING AND WRITE-OFF POLICY

10.1 Revenue Recognition

The Bank adopts the policy to only recognise as revenues payments received from customers in the currency and on the account(s) agreed upon in the legal, duly signed documents that constitute the relationship, mutual rights and obligations between the Bank, the customer and any third parties. Revenues from other sources will be recognised when they have been received in freely convertible currency.

Gains on sales of equity investments are credited to income when received in freely convertible currencies. The value of the local currency, in which the proceeds of the sale may be denominated, will be determined by the Bank by taking into account the rate of exchange prevailing in the market at the time of such payment. For this purpose the Bank may consult any appropriate source, including the monetary authorities of the country concerned and the IMF.
10.2 Policy on Loan Restructuring / Rescheduling

As an international financial institution, the Bank has preferred creditor status over all commercial creditors. Other institutions also enjoy a preferred creditor status. This means that the Bank will:

i) not normally reschedule debt payments or participate in debt rescheduling agreements with respect to its loans to, or guaranteed by, its member countries of operations, except in circumstances where rescheduling provides the best means of protecting the Bank's interest; and

ii) not reschedule its loan to a private sector borrower where the borrower's ability or anticipated inability to service its debt is due to a general foreign exchange shortage in the borrower's country.

In circumstances where rescheduling provides the best means of protecting the Bank's interest, the Bank may consider to restructure the repayment terms of existing operations to private sector borrowers. The Project Implementation and Monitoring Department submits a proposal to restructure the operation to the Credit Committee, which determines pursuant to certain general principles if the circumstances are correct and decides on the implementation of the proposal. The overriding principle ruling the decision is that restructuring turns out to be the best out of all alternative courses of action that have been considered, including selling-off the loan and/or equity investment and the liquidation of the borrower/obligor. The Bank will never deem restructuring to be appropriate merely for avoiding a default. If the financial condition of the borrower/obligor deteriorates beyond the point of sustainability, the Bank will pursue liquidation or settlement.

The decision to restructure / reschedule the exposure will be normally made subject to the condition, that other financiers, investors and creditors of the borrower/obligor share the burden of the company's difficulties by providing additional equity, rescheduling their loans, or a combination of these, as well. The rescheduling is thus part of an overall scheme aimed at turning around c.a. revitalising the company. The plan must enable the company to achieve financial viability, as measured by its projected ability to servicing its debts/obligations out of future cash flows.

Restructurings / reschedulings that provide for repayments beyond the time schedule as originally authorised by the Board, will be subject to approval by the Bank's Board of Directors.

10.3 Policy on Write-offs

Private Sector Assets

The Bank will take appropriate measures according to internally approved rules and procedures to workout non-performing assets through all possible means before deciding to write-off the remaining not recovered exposure.
The Bank will write-off any remaining exposure against the provision only after it has determined that there are no credible chances that the client will be able over a reasonable period of time (e.g. liquidated) to repay any remaining obligation, and that the exposure must be considered unrecoverable. Any revenue to the Bank from a written-off exposure irrespective of its origin (call of guarantee, use of collateral, exercise of security, payment by owner/sponsor, etc.) shall be recognised at time of receipt as exceptional income.

Sovereign and Sovereign-guaranteed Assets

The Bank will not participate in debt write-offs or debt reduction exercises of sovereign or sovereign-guaranteed assets, except in highly exceptional circumstances, following consultations with the obligor or guarantor, as appropriate, and only after securing approval from the BoG.

11. CORPORATE GOVERNANCE

Basic Principles

The Bank is committed to effective corporate governance with responsibilities and related controls throughout the Bank properly defined and delineated. Transparency and accountability are integral elements of the Bank's corporate governance framework. The corporate governance structure is further supported by a system of reporting, with information appropriately tailored for and disseminated to each level of responsibility within the Bank to enable the system of checks and balances on the Bank's activities to function effectively.

The Bank's corporate governance structure is subject of the Corporate Governance Framework.

Information Support

The Bank's corporate governance is supported by appropriate financial and management reporting. With respect to external financial reporting, the Bank will present financial statements in its Annual Report, prepared in accordance with the International Accounting Standards. In its financial reporting the Bank aims to provide appropriate information on risk and performance of its activities. Industry best practice will guide the evolving disclosure practice in public financial reports.

As regards reporting, the Bank will have in place a comprehensive Management Information System of reporting to the Board of Directors on:

- Operations and investment pipeline
- Administrative expenses
- Credit developments
- Financial results
- Technical cooperation
In addition, detailed information will be available to permit Management to monitor the implementation of strategies and business plans, and the execution of budgets. This information aims at enhancing accountability throughout the organisation.

**Financial Planning**

The Bank is committed to tight budgetary discipline within a framework of *budgetary policies* that aim at maintaining a balance between an appropriate allocation of resources and operational objectives.

The Bank's approved budget comprises an annual budget for administrative expenses and an annual capital expenditure program. The approved budget may also include a general contingency that can be appropriated to a cost category during the year at the discretion of the President and reported to the Board of Directors.

The planning and budgeting process are subject to the BoD approved Strategic Planning and Budgeting Policy.

**Compliance and Operational Risk**

Compliance with laws, rules and standards helps to maintain the Bank’s reputation with, and thus meet the expectations of, its customers, the markets and society as a whole. Compliance risk is defined as the risk of legal sanctions, material financial loss, or loss to reputation the Bank may suffer as a result of its failure to comply with laws, its own regulations, code of conduct, and standards of best/good practice.

Operational Risk brings together all aspects of risk related exposure other than those falling within the scope of the definition of market and credit risk broadly defined. A comprehensive approach towards operational risk shall be established, based on prevention, mitigation and responsive remedial action.

The Compliance and Operational Risk Management Office is a unit independent of the business activities of the Bank. The Head of the Office is reporting to the President of the Bank and the Board of Directors through the Chairman of the Board of Directors. The detailed attributions, responsibilities and scope of activities is defined in the Charter of the Compliance and Risk Management Office.

The Compliance and Operational Risk Management Office i) identifies, assesses, advises on, and monitors the Bank’s compliance risk, and ii) identifies, assesses, monitors and controls/mitigates the operational risk inherent in all material products, activities, processes and systems.

For the purpose of fulfilment of its activities and in order to identify and manage compliance and operational risks at an early stage, the Compliance and Operational Risk Management Office establishes cooperative relationships with other relevant organizational units in the Bank. Close co-operation is also established between the Compliance and Operational Risk Management Office and other risk management units with respect to the provision and exchange of relevant advice and information and the cumulative reporting of the compliance and operational risks.
Control of compliance and operational risk within the Bank shall rely heavily on the fundamental framework of sound banking practices, with appropriate checks and balances and segregation of duties. This framework will be based on:

- An overall culture of control and responsibility
- Staff of experience and high integrity
- Detailed, complete and accurate accounting and operational records
- Control over access to the Bank’s assets and systems
- Compliance with established operational procedures.

**Key Policies**

All of the above elements of the control framework depend on the existence and adequate documentation of key policies. The Bank shall establish such policies to cover all major aspects of compliance and operational risk to include:

- Code of Conduct
- Staff Regulations
- Disciplinary Measures and Procedures
- Grievances and Appeals Procedures
- Disaster Recovery/Contingency Planning
- Policy on Disclosure of Information and Confidentiality
- Anti Fraud, Corruption and Money Laundering Policy
- Operational Risk Management Policy
- Information Technology Policies and Guidelines
- Procurement Principles and Rules

**Internal and External Auditors**

*Office of the Internal Auditor:* the Bank’s Internal Audit Department is an independent, objective, assurance, and consulting activity that examines and evaluates the activities of the Bank as a service to management and the Board of Directors. Although the Internal Audit Department reports functionally to the President, the Audit Committee of the Board of Directors has the responsibility, inter alia, of satisfying itself that the internal audit process is adequate and efficient through reviewing the policy, the scope, the work programme and the reporting relating to the Internal Audit Department. The primary objective of the Internal Audit activity is to help management and the Board of Directors of BSTDB discharge their responsibilities and accomplish the objectives of the Bank by bringing a systematic, disciplined approach to evaluate and improve effectiveness of risk management, control, and governance processes. Internal Audit furnishes them with analyses, recommendations, counsel, and information concerning the activities reviewed. The Internal Audit Department carries out its work according to the Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors.
Its authority and responsibility is defined in the Bank’s Internal Audit Charter, which is approved by the Audit Committee. Additionally, Internal Audit carries out any specific audit requests or investigations upon the request of management and the Board of Directors and also acts as coordinator with the external auditors of the Bank.

*External Auditors*: the Board of Governors appoints the External Auditors on the recommendation of the Board of Directors, for a one-year term. At the conclusion of their annual audit, the External Auditors provide a signed auditor's opinion on the truth and fairness of the Bank's Financial Statements and separate signed auditor's opinions for each of the Bank's special operations. Additionally, they prepare a Constructive Comments Letter and/or a Management Letter, setting out the Auditors’ views and Management’s responses on the effectiveness and efficiency of controls. This Letter(s) is reviewed in detail and discussed with the Audit Committee. The performance of the External Auditors is subject to regular review by the Audit Committee.