Financial Sector Policy

1. Introduction

The Bank sets up its Financial Sector Policy in accordance with the provisions in the Articles Establishing the Black Sea Trade and Development Bank. Article 1 of the Agreement states the purpose of the Bank as: "*The purpose of the Bank shall be to effectively contribute to the transition process of the Member States towards the economic prosperity of the people of the region and to finance and promote regional projects and provide other banking services to projects of the public and private sectors in the Member States and trade activities among the Member States.*" In order to successfully fulfill its purpose, Article 2 of the Agreement details a number of functions that the Bank has, among which:

- *to cooperate with international development institutions and national finance and development agencies of the Member States;*

- *to undertake research and surveys for promoting economic development of the region of the Member States or any of the Member States in order to stimulate development and transition;*

- *to further the aim of regional cooperation for development and to cooperate with the Member States to orient their development policies towards better utilization of their resources in a manner consistent with the objective of making their economies more complementary and of fostering the orderly growth of the economies of the Member States and acting as an advisor in designing sound economic policies;*

- *to undertake such other activities and provide such other services as may advance its purpose.*

The Financial Sector Policy document of BSTDB has two main purposes:

1. To provide information on the current state of development, strengths and weaknesses and trends in the Member States of BSTDB; and

2. To provide a set of guidelines for operations in the financial sector, setting objectives, identifying limitations and stating priorities for the Bank's involvement in financial sector activities.

The policy for the financial sector defines the role of the Bank in dealing with financial institutions in three dimensions:

(i) partners (co-financiers);
(ii) vehicles (intermediaries); and
(iii) clients (borrowers and investees)

in order to foster cooperation with firms, promote development of financial markets, and improve and expand financial services and products available. It elucidates where the Bank provides assistance and the products to be employed.

The main aim of Bank involvement in the financial sector is, in conformity with its mandate, to promote regional cooperation and social and economic development. At the same time the Bank will pay careful attention to the most cost-effective ways to improve delivery of financing to entrepreneurs and firms, while duly taking into account the necessity for the financial institutions to adequately evaluate and protect against risks.

2. Promoting the Financial Sector: an effective way to foster economic development

In order to promote economic development, it is of particular importance to Member States to foster the development of their market institutions and provide a level playing field to all market participants. The financial sector plays a pivotal role in economic development. But for the financial sector to play its role good regulation and supervision need to be in place, property rights need to be well defined, and institutions need to be strong and able to enforce needed legislation (banking law, bankruptcy law, company law, secured transactions, contractual discipline, etc).

In light of the above, it becomes even more important for Member States to create the legal framework and business environment conducive to the development of local financial institutions (irrespective whether domestically or foreign owned). In order to increase savings a solid financial sector needs to evolve, in some countries from a very rudimentary starting point.

The financial sector is a key engine of growth as it makes savings available to the enterprise sector that in turn uses them for productive purposes. It is therefore necessary that financial institutions develop risk management skills that would allow them to protect adequately against losses, and thus help restore public confidence damaged during recent crises. Financial institutions should both develop saving instruments that appeal to savers and offer products desired by borrowers.

Credit to the enterprise sector, in particular medium and long-term, is in short supply and is a precondition for productive investment and economic growth. The monetary sector and the real sector are linked through financial institutions; stronger financial institutions attract higher savings, higher savings increase lending and investment, which in turn result in higher rates of economic growth.

Provision of medium term finance by the Bank and additional mobilization of domestic and foreign capital represent a significant contribution towards reducing the difficulties enterprises, in particular SMEs, face in accessing medium to long-term finance. Thus the Bank will help selected financial institutions strengthen their balance sheet, match better assets with liabilities, diversify client base, improve portfolio quality. Consequently, the confidence of the general public in the respective financial institutions may increase with positive implications in many areas of activity.

2.1 *Reasons that justify special attention on the Financial Sector*

- ***Existing market failures and imperfect competition***

The efficiency of the financial markets depends considerably on the macroeconomic environment. Decisions to lend and borrow are made on the basis of interest rates, exchange rates, and inflation rates prevailing at the time they are made, and also on the expectations that market participants form about these variables and about policy decisions that may alter the business environment. Current and expected levels of public sector and current account deficits, and the volatility in economic rates of growth have direct effects on lending and borrowing decisions.

Risk and uncertainty still place a heavy burden on financial institutions, as the cost of intermediation is high. Core deposits represent a small fraction of bank liabilities, with term deposits in excess of 12 months practically inexistent. Lending interest rates frequently are prohibitively high, over 10 percent in real terms, which increases the risk of adverse selection in banks.

Banks do not generally engage in term transformation and therefore the amount of capital available for medium to long term transactions is very limited. Large companies, usually linked to multinationals through ownership, management or purchase of output, are favored in the allocation of the scarce credit, thus leaving out cash starved locally owned SMEs or former state owned enterprises privatized to local interests.

The banking sector is highly segmented, with few banks dominating the market as suppliers of funds to specific preferred sectors (state-owned enterprises, trade houses, agriculture), with most of the private enterprises cut-off from the formal financial sector.

Given the above-mentioned market, legal and institutional specificities, BSTDB involvement must be very carefully considered. The Bank's size and capabilities do not allow for an active involvement on the policy front in a manner able to generate results commensurable with the effort required. Market failures are a fact of life and offsetting those can go only a certain well defined way, beyond which the Bank may not have control over the evolution of events. Indeed this is a role more appropriate for larger global policy oriented institutions, such as the World Bank or the IMF. Nevertheless, cooperation with other IFIs, international organizations, government agencies and development institutions is desirable, in order to ensure that the Bank's operations do not take place in a hostile environment that would endanger the success of the operation or the prospects for repayment.

The Bank may attempt to correct for specific conditions, not directly linked to the policy or regulatory environment, that: (i) prevent the healthy development of specific types of financial institutions; or (ii) limit provision of finance at reasonable terms to a target group of companies or specific sectors.

An important objective of the Bank is to facilitate development of more solid banks, and financial institutions in general, support specialized credit institutions focused on providing micro-finance and loans to SMEs, or Credit Guarantee Funds.

The Bank may only be effective at the individual financial institution level. It shall therefore analyze with maximum possible attention the prevailing market, legal and institutional conditions, with a view to assessing the impact and effectiveness of Bank involvement.

One important measure of Bank's effectiveness is sustainability of operations; the degree to which the financial institution beneficiary of Bank financing continues successful operation on the specific line of business after the Bank stops providing financial support. The Bank's role should primarily be that of a catalyst; this should not remain a policy statement, but become a measurable indicator of success.

- ***Mobilizing domestic and foreign capital***

An important result that BSTDB expects to achieve from its operations in the financial sector is the increased allocation of credit for productive activities in Member States. The Bank should also attempt to maximize the positive externalities generated by the use of the Bank's products and, possibly if special funds are available, technical assistance.

To this end, the Bank will support co-financing with domestic financial institutions, as a way to mobilize available domestic capital. In addition the Bank shall seek co-financing opportunities with other IFIs, development institutions, international organizations, public and private financiers, and other donors.

Given the level of resources it has available, the Bank shall attempt to make an as visible as possible contribution with a view to increasing the confidence savers and partners have in financial institutions that work closely with BSTDB.

- ***Supporting private sector development***

The private sector cannot develop without adequate levels of capital. Capital is to be provided primarily by shareholders (equity and subordinated loans), but often such a source of funds is rapidly exhausted with the acquisition of necessary basic equipment and plant.

Additional capital that may be provided in the form of equity or quasi-equity is urgently needed. This not only strengthens the financial condition of the respective company, but would in addition increase its access to fresh bank credit (helping thus the mobilization of domestic capital).

Medium-term (1 to 5 yrs.) credit for exporting companies would contribute to increased efficiency of production, job creation, higher output, and consequently generation of higher levels of income.

Through the financial sector the Bank would be able to increase its outreach capacity and to provide funds to a large number of medium sized companies engaged in the production and export of goods and services.

A stronger private sector would be beneficial for public finances, and for society in general; a critical mass of wealth accumulation and the development of a middle class would aid social cohesion and political stability.

3. BSTDB Role and Priorities

BSTDB can address many of the issues mentioned above through selective cooperation with financial intermediaries. Bank funding may improve the liability structure of partner financial institutions, help them diversify their portfolio and improve risk management, thus helping them to better serve the needs of the emerging private sector.

Careful monitoring by the Bank of the use of funds offered for intermediation would ensure the access to finance of well managed local companies, contributing to the establishment of good working relations between the intermediaries and the enterprise sector and ensuring their access on a more permanent basis to credit.

BSTDB hopes to play a central role in the promotion of the SME sector in Member States, higher trade volumes, and economic integration through increased flows of intra-regional investments. This role may be effectively expressed through adequate association with locally incorporated financial intermediaries.

3.1 Partners (Co-financiers)

The Bank works with two types of partner financial institutions:

- International Financial Institutions (IFIs) and Official Development Agencies; and
- Financial sector institutions (e.g. commercial banks, leasing companies)

(i) International Financial Insitititutions

The Bank cooperates with IFIs (EBRD, IFC, MIGA, CEDB, NIB) and official development agencies of non-BSEC countries (KfW, SENTER, JBIC, FMO) to promote economic development and economic integration of Member States. This is done through use of the following products:

- co-financing of projects;
- provision of guarantees for increased inflows of foreign exchange into the region; and
- mobilization of additional capital to be used for financing of productive activities in Member States.

(ii) Financial Sector Institutions of Member States

As partners, domestic financial institutions co-finance with BSTDB projects and programs aimed at the development of markets and of the Member States economies' more generally.

This activity includes two types of partnership:

- a project in a Member State is financed jointly (or in parallel) by the Bank and local financial institutions, in order to mobilize domestic capital; and
- a special purpose credit line provided by the Bank to a financial institution (as intermediary) in a Member State is supplemented by the respective intermediary, such that in each sub-loan a certain proportion of funding is provided from the intermediary's own resources.

3.2 Vehicles (Intermediaries)

As vehicles, domestic financial institutions are used to help channel funds to productive enterprises involved in trade activities and to the SME sector. It represents the preferred relationship that the Bank desires to establish with financial intermediaries in Member States.

As intermediaries financial institutions in Member States receive funds from the Bank and on-lend them to final beneficiaries.

- *Agreed Financial Intermediaries*

  Financial intermediaries must meet minimum eligibility criteria and, where appropriate, provide an acceptable plan for institutional development. Normally, the intermediary should not use Bank funds in a capacity of fiscal agent; if this were to happen for clearly documented developmental reasons, then a sovereign guarantee should be required.

  Intermediaries are assessed and selected in conformity with the Bank's approved "Guidelines for the appraisal and selection of financial intermediaries".

  The Bank, as a rule, should not be involved in the details of the approval process of sub-loans, reserving oversight for large sub-loans/investments above a certain level, and concentrating attention on the overall operation of the intermediary itself. However, the Bank reserves the right to request intermediaries to submit sub-loan applications, or a subset thereof, to the Bank for no objection. The intermediary is responsible to the Bank for providing acceptable evidence that the funds extended by the Bank are used according to the pre-agreed destination purpose.

As a rule, the Bank will only take the risk of the financial intermediary, and not that of the recipient of the sub-loan. Notwithstanding this general principle, the Bank may require security in a variety of forms, including pledge of the security obtained for the sub-loans financed with Bank's money, insurance policy, mortgage, receivables and other assets of the sub-borrowers, in lieu or in addition to the security required from the intermediary borrower.

- *Interest Rate and Exchange Rate Policies*

It is an established practice that the interest rate is market determined. As in direct operations, a detailed risk analysis – in conformity with the approved methodology – determines a risk margin range that combines project and country risk. The final contractual interest rate is negotiated and agreed with the financial intermediary fully taking into account the provisions of the Bank's pricing policy. The interest rate may be fixed or variable.

The Bank should not be prescriptive about the terms and conditions on which the intermediary provides financing to final beneficiaries. However, in such cases where Bank financing behaves as an implicit subsidy for the intermediary or the end-user, a pre-established on-lending margin that takes into account the estimated rate of return on investment may be agreed, if the Bank deems appropriate. In short, the Bank should not be concerned with the level of on-lending rates, except in specific cases of significant distortions, or administratively controlled interest rates. As there is a trade-off between systemic and institutional concerns, any problem must be treated on a case-by-case basis depending on the specific conditions prevailing at the time of the operation.

From the Bank's perspective the foreign exchange risk is born by the primary beneficiary of the financing - the financial intermediary itself. There is no justified argument in favor of the Bank's involvement in the setting of the on-lending interest rate or the share of burden of the foreign exchange risk between the financial intermediary and the final beneficiary of the funding. These issues are left at the discretion of the intermediary. The arrangement between the intermediary and the end-user/final beneficiary is of no concern to the Bank, as the intermediary must be given the freedom and authority to make the best decision on the basis of all available information.

- *Project Evaluation, Supervision and Monitoring*

Project evaluation would be difficult and costly were it to be performed by the financial intermediary according to the Bank's requirements for each individual sub-project. It is therefore advisable that such evaluation be performed only for large sub-projects that need the Bank's no objection, or in cases where significant distortions exist and make simple and straightforward financial calculations unreliable. For the majority of sub-loans supervision and monitoring will be conducted by the intermediary according to its own internal procedures, provided that these are acceptable to the Bank, or according to a standard pre-agreed procedure reflected in the legal agreements.

The Bank will perform project evaluation on the overall purpose and scope of the operation to be implemented through the respective financial intermediary. The intermediary in turn will perform according to its own internal methodologies the evaluation of sub-projects. However, it would be beneficial if the Bank would be provided with such methodologies and would have the chance to assess their adequacy and acceptability.

Monitoring the performance of the operation may include aspects of the relations between the intermediary and final beneficiaries, and therefore has a greater scope than supervision. Moreover, it includes an assessment of the degree of compliance with covenants and of performance against monitoring indicators. Project evaluation includes a more detailed look at the performance of final beneficiaries in their relation with the intermediary, as well as a post factum assessment of the adequacy and quality of the initial objectives and a qualitative assessment of their degree of realization.

Ultimately it is important that the Bank be reimbursed and that the funds entrusted to the intermediary are used for the intended purposes while the anticipated results are achieved.

3.3 Clients (Investees)

As clients, financial intermediaries may benefit from financing in the form of debt, or guarantee. In exceptional circumstances, the Bank may consider providing also equity. These operations are directed towards the development and strengthening of financial institutions, increasing the liquidity of the market, supplying credit to specific sectors or activities (manufacturing, agro-processing, tourism, export), and diversification of financial products.

As clients, financial institutions benefiting from Bank funding should be involved in any, or a combination thereof, of the following activities:

- Commercial banking
- Microfinance institutions
- SME finance institutions
- Leasing companies
- Credit guarantee funds
- Export promotion/credit agencies
- Equity Capital Funds

4. Scope of Operations in the Financial Sector

The Bank financing of the financial sector must reflect the priorities of the Bank and conform to relevant Bank policies and strategies. The role of the Bank must be prominent and its contribution identifiable and visible qualitatively, or measurable quantitatively.

Bank operations in the financial sectors of Member States encompass two different approaches, each with its specific set of objectives:

- Creation/Strengthening of specific types of financial institutions;
- Promotion of selected sectors or activities.

4.1 Promotion of selected sectors or activities

This activity concentrates on the end-uses of funds. Bank funds may be provided on a stand-alone basis or may be added to a pre-existing fund or credit line. Where the Bank may mobilize additional resources from the intermediary itself this approach should be pursued as it provides a number of benefits: (i) mobilizes additional domestic capital; (ii) given the inherent fungibility of money, the Bank must ensure that its resources do not merely replace existing availability of funding, but that it is additional; and (iii) increases the risk awareness of the intermediary, as it has something significant at stake.

This type of intervention by the Bank is justified on grounds that:

- In developing and transition countries, savers and intermediaries have greater aversion to risk than usually in developed countries;

- Improper information, inadequate enforcement of contracts, incomplete property rights, scarce reliable financial information, unstable macroeconomic environment, make provision of financing to specific sectors of the economy and more generally long-term financing too risky for the preference of savers and financial institutions;

- The Financial sector disposes of limited financial resources, that lead to a significant financing gap;

- The operation entails important externalities from the promoted activity that results in higher social benefits than the private (financial) benefits which influence the decisions of lenders and investors.

Specific sectors and activities that qualify for support through financial intermediaries are, in particular, SMEs in: manufacturing, foreign trade, agribusiness, market and social services.

4.2 Creation/Strengthening of specific types of financial institutions

The ultimate purpose of this activity is to support the development of the real sector. Examples include, but are not limited to, support for development finance, microfinance banks, mortgage banks, leasing companies, credit risk funds, equity funds, dedicated credit lines, with the purpose of providing increased amounts of term finance. Such institutions should play a catalytic role, and provide a clear demonstration effect, to be eligible for Bank financing.

However, care must be exercised to avoid support of institutions that are adversely affected by a policy environment that prevented in the first place the genuine development of similar market based institutions.