Guidelines for the Appraisal and Selection of Financial Intermediaries

Introduction

These guidelines are adopted by the Board of Directors pursuant to the provisions of the Rules and Regulations for Financing Projects and Commercial Activities and the Portfolio Risk Management and Investment Policies.

In addition to establishing general guidelines for the appraisal and selection of financial institutions, the present document sets general principles for the use of financial institutions in Bank financed operations.

1. Purpose of Selecting Financial Institutions

The Bank will work with selected financial institutions as intermediaries in its countries of operation where such delegation of responsibility assists the Bank in servicing a market segment more efficiently or effectively than the Bank might be able to do directly.

BSTDB's involvement with financial institutions may take the form of lending, equity participation, or provision of guarantees. In all cases, the selected financial institution must meet the Bank's criteria outlined in this document.

The present Guidelines cover the selection and use of financial institutions by the Bank in their capacities of vehicles (intermediaries) or clients (investees) for: (i) on-lending (SME credit lines, guarantees, trade finance facilities, other program finance operations); and (ii) capacity development and institutional building financing (debt, equity, guarantees), respectively, and shall constitute the basis for individual legal agreements governing such operations.

The document provides the principles to ensure qualification of financial institutions for participation in Bank financed operations in conformity with the Portfolio Risk Management and Investment Policies document, Financial Sector Policy and SME Sector Strategy in BSTDB Member Countries – Financing Strategy for Development and Cooperation.

The appraisal and selection of financial institutions to participate in Bank financed operations is done with the observance of the procedural requirements set forth in the Operations Cycle Policy and following the detailed procedures in the Operations Manual.

The four main areas of activity, which most likely would be conducted more efficiently through financial institutions, are:

(a) trade finance;
(b) SMEs finance;
(c) program lending (e.g. credit lines, other forms of debt);
(d) equity participation.

as detailed in the Portfolio Risk Management and Investment Policies.

2. Administrative Specifications

2.1 Use of Bank Funds

In line, with the Bank's mandate, use of Bank funds should have a strong development impact, encourage and strengthen regional cooperation, and foster trade among member countries. Transition to prosperity and sustainable economic growth should be targeted as the ultimate goal of Bank involvement. Specific goals of the particular operations, including sub-projects, will be detailed in the loan agreements, and must meet the Bank's eligibility criteria. Bank funds may be disbursed only for the purpose specified in the legal documentation.

2.2 On-Lending Terms

In all cases, terms and conditions for Bank lending to the financial intermediaries, follow the guidelines covering loans exposure, currency, repayment, and principles of loan pricing set forth in the Bank's Portfolio Risk Management and Investment Policies, and have priority over any local arrangements and practices. The on-lending terms follow the policy prescriptions set forth in the Financial Sector Policy.

3. Principles for the Appraisal and Selection of Financial Institutions

3.1 Rationale for the Process

Given the importance of financial intermediaries for the Bank's operations, the internal selection procedures must ensure that approved Financial Institutions (FIs) meet the required standards of transparency and sound banking principles, and represent promising regional financial institutions with which to cooperate.

On a priority basis, FIs should be selected in connection with a specific operation, either at the recommendation of an Operation Leader or as a result of an application by an interested financial institution. However, the selection and due diligence process needs to be conducted independently and impartially.

A FI may participate, simultaneously or sequentially, in a number of similar or different operations; the only restrictions being that (i) aggregated authorized exposures remain within the maximum exposure limit for that particular FI, and (ii) each individual operation be within the maximum maturity, with both limits to be established by the Risk Management Department (RMD).

3.2 General Principles Guiding the Appraisal of Financial Institutions

The selection process of acceptable participating financial intermediaries in Bank sponsored projects and programs requires careful analysis in the following areas:

1. Operating environment, including:

    (i) ownership structure;
    (ii) macroeconomic environment;

(iii) legal framework governing financial sector institutions and operations;

2. Evaluation of financial intermediaries, including:

(iv) eligibility criteria;
(v) appraisal.

In addition, a very important element in the decision to select a financial institution as participating intermediary is the demonstrated capability, experience and willingness to do the particular business required for the successful implementation of the Bank financed operation.

The appraisal of financial intermediaries is a multi-staged process, with contributions from the Financial Institutions Departments, RMD and FAD.

3.2.1 Ownership Structure

The ownership structure of a FI is a crucial factor in determining the acceptability of the institution for the Bank's purposes. Experience has demonstrated that banks which belong to a group of companies owned, or in majority controlled by, a single entity can be used as sources of cheap financing by other companies in the group, with little or no attention paid to sound banking principles. Thus, banks whose assets include a significant number of inter-company loans should be examined with great care, especially when the group of companies to which the bank belongs is controlled by a single person/entity. The element of ownership, including but not limited to the integrity of the main shareholders, will be fully explored when conducting the analysis of a potential FI.

In addition to the ownership structure, various other qualitative factors, such as quality of corporate governance, adequacy of staffing, and market knowledge of the institution shall be considered.

3.2.2 Macroeconomic Environment

Given the critical importance of the macroeconomic framework for the stability of the financial sector, the Bank will consider using financial intermediaries mainly within the context of a satisfactory macroeconomic framework. Thus, the following elements will be examined when assessing the adequacy of the macroeconomic environment:

- Existence of interest rate distortions, dual interest rates, or segmented markets;
- Multiple currencies in use;
- Multiple exchange rate practices, parallel foreign exchange markets;
- PSBR (public sector borrowing requirement), maturity/structure of debt, BoP (balance of payments), foreign debt;
- Fiscal and monetary policy, tax collection, public sector deficit
- Economic indicators (inflation, GDP, unemployment, etc.)

3.2.3 Legal Framework for Financial Sector

The Bank will seek to use intermediaries only in those countries of operation where the financial sector is adequately regulated and financial institution supervision is carried out in a manner satisfactory to the Bank. For this purpose, the Bank will take into consideration:

- Existence, adequacy, and enforceability of prudential regulations;
- Degree of independence from political interference of the regulatory and supervisory authorities;
- Quality of the decision-making process in financial institutions;
- Staffing and professional capacity of the supervisory authority to carry out off-site surveillance and on-site inspections;
- Accounting and auditing standards;
- Legal treatment of troubled financial institutions;
- Development of judicial system;
- Financial system liberalization and proper level playing field;
- Deposit insurance legislation and institutional arrangements.

3.2.4 Financial Analysis

Analysis of the institution's financial health will include an evaluation of the accepted ratios based on audited accounts according to International Financial Reporting Standards (IFRS) and other numerical elements considered by reputable rating agencies and other organizations specializing in the surveillance of financial institutions. Attention will be given, in particular, to: (i) solvability and degree of impairment of capital; (ii) quality of assets and level of provisions; (iii) evaluating the sustainability and quality of earnings; and (iv) adequacy of liquidity. The financial analysis shall be performed in conformity with the provisions of the Operations Manual. The specific variables for the financial intermediaries include:

- Capital adequacy
- Earnings
- Liquidity
- Effectiveness of loan administration (appraisal, supervision, and collection)
- Adequacy and timeliness of audited financial statements

4. Supervision and Monitoring of Selected Financial Institutions

During operation appraisal and negotiation, provision is made for effective and continuous monitoring and evaluation of the financial intermediary's progress towards its objective, as well as its continued eligibility status. The performance indicators agreed on during negotiations might include economic, sectoral, financial, and institutional variables. These variables closely parallel those used for the analysis of financial institutions.

During implementation of operations involving FIs, the Bank will conduct the supervision and monitoring activity in conformity with the provisions of the Operations Manual.

4.1 Reporting Procedures to be Followed by Financial Institutions

The Bank requires all borrowers to provide regular reports of an agreed form and content during the operation implementation period. Usually, at loan negotiation, the Bank agrees with the financial intermediary on the form and content of the reports, which must be in line with the following general guidelines:

- Annual audited financial statements (where appropriate, the audited financial statements will restate financial statements prepared locally, but in accordance with International Accounting Standards: In cases where cumulative inflation for the last three years exceeds 100 per cent, inflationary accounting procedures according to IAS 29 will be applied);

- Interim audit reports and quarterly financial statements, or provisional financial statements in cases when quarterly financial statements are not available;

- A statement of major changes in the financial intermediary's financial policies and practices introduced over the period covered by the report, indicating whether these changes resulted from decisions of the board of directors, management, or economic/regulatory authorities;

- A summary of magnitudes and trends of major operations (e.g. lending, investment, discounting, off-balance sheet activities);

- Such details as the Bank may reasonably request on the use of Bank funds (commitments, disbursements, nature of beneficiaries, pertinent financial information on the sub-borrowers, Terms & Conditions of the sub-loans, details on goods and services financed and methods of procurement, risk classification of loans under Bank funds, security type or other arrangements, level of provisions, repayment profile, destination of exports/ origin of imports);

Such other information as the Bank considers necessary for its review purposes.