Black Sea Trade & Development Bank

BANKING PORTFOLIO RISK MANAGEMENT AND INVESTMENT POLICIES

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PART I

BANKING PORTFOLIO RISK MANAGEMENT

1. Conformity of Limits

All policies and limits elaborated in this document are in conformity with the guidelines specified in the Agreement Establishing the Black Sea Trade and Development Bank (Establishment Agreement), the Rules and Regulations for Financing Projects and Commercial Activities, and the Bank's Financial Policies.

2. Purpose of Limits

The Bank conducts its operations in one of the world's most dynamic regions, and the Bank's governing authorities expect operating conditions to continue to change within relatively short timeframes. The Bank's ability to assume risks must be considered in light of its mandate, of its capital base and operating benefits in the medium and long term, and of projected growth.

Establishing and maintaining the Bank's good reputation is of paramount importance. To achieve this aim, as well as to attract financing on reasonable terms and conditions, a set of portfolio risk limits has been devised which will allow the Bank to operate within prudent exposure parameters in line with international best practices. The portfolio risk limits do not represent operational disbursement targets. Rather, they are meant to be a framework within which individual product guidelines, pricing, and investment strategies are to be set. Additionally they restrict exposure to acceptable limits.

The Bank recognizes three types of limits. They are, in descending order:

- Limits set in the Establishing Agreement. These limits are institutional, and can only be amended according to the procedures described in the Establishment Agreement.

- Limits set by the Portfolio Risk Management and Investment Policy. These limits are operational, and can be amended by a decision of the Board of Directors upon the recommendation of the Bank's President. Operational limits may only be more stringent than the institutional limits.

- Limits set by the Management Committee at the recommendation of the Credit Committee or ALCO. These limits affect the day-to-day operations of the Bank. These limits may only be more stringent than the institutional and/or operational limits. The limits set up at the recommendation of the Credit Committee and ALCO will be reported to the Board of Directors.

The risk limits elaborated in this document are conservative. Unless specified otherwise, all limits described in this document may be modified in accordance with the aforementioned procedure. Unless specifically stated, all limits apply simultaneously; for day-to-day operational purposes the most restrictive/risk-averse ones apply with priority.

3. Overall Portfolio Limits

Limits from the Agreement Establishing BSTDB

Category	Art. In the Agreement	Limit
Total portfolio limit for outstanding loans, guarantees and equity investments	Art. 15,(1)	1.5 times the Bank's unimpaired subscribed capital, reserves, and surpluses included in its Ordinary capital resources.
Total disbursed equity investment	Art. 15,(3)	Total unimpaired paid-in subscribed capital[1], surpluses, and general reserves.

3.1 Total portfolio limit (Gearing Ratio)

According to Art. 15(1) of the Establishment Agreement, the total amount of outstanding loans, equity investments and guarantees shall never exceed 150% of the total amount of the Bank's unimpaired subscribed capital, reserves, and surpluses. This 'Institutional Gearing Ratio' corresponds only with the Ordinary Capital Resources, thus excluding Special Fund resources and related operations. Special Fund resources and related operations will be administered to the specifications of donor entities.

In addition, in order to secure a prudent ratio of shareholder funds to the outstanding portfolio of active operations, the Bank establishes an operational target set at 100% of the sum of (i) the Bank's unimpaired paid-up capital and the usable portion of callable capital, (ii) reserves and surpluses, and (iii) the amount of reserves and surpluses times the ratio of the Bank's usable portion of callable capital to the Bank's unimpaired paid-up capital[2]. This is referred to as the 'Operational Gearing Ratio' and may only be exceeded by special permission of the Board of Directors.

For the purpose of clarifying and providing a common understanding for practical purposes of the term unimpaired subscribed capital, referred to in Article 15, Par.1 of the Establishment Agreement, the following definitions apply:

- Unimpaired paid-up capital constitutes that portion of subscribed capital represented by the fully paid and payable shares (see paragraphs 2(a) and 2(b) of Art. 5 of the Establishment Agreement) which is actually paid by Member States and is in rightful use by the Bank and which is not earmarked or otherwise construed to cover any uncovered liability of the Bank, including losses and decline in the real asset value bellow the value of liabilities that are in excess of the Bank's accumulated reserves and surpluses and applicable deductions from provisions;

- Reserves and Surpluses represent the accumulated surpluses, including undistributed and unpaid dividends to Shareholders, and the reserves of the Bank (general and specific loan loss provisions are not included in this definition);

[1] For the purpose of this document and all subsequent common interpretation of the terminology, paid-in capital constitutes that part of subscribed capital represented by the (i) fully paid and (ii) payable shares (paragraphs 2(a) and 2(b) of Art. 5 of the Establishment Agreement), and excludes callable capital

[2] By way of explanation, given the 30% paid up/ 70% callable ratio of the Bank's capital, this ratio stands at 70/30, or 7/3, following the final scheduled payment of the 2008 capital increase at end 2018.

- Usable Portion of Callable Capital represent that portion of the 70% of the subscribed unpaid but callable shares, determined for each Shareholder as the proportion of its effectively paid up (contributed and in rightful use to the Bank) portion of the first two categories of subscribed and issued capital stock (first category representing 10% of fully paid shares, plus second category representing the due portion of the 20% capital stock subscribed and payable according to the schedule first described in Article 6, Par. 3 of the Establishment Agreement and subsequently decided by the Board of Governors) out of its came due obligations for the two categories of shares.

- 'Outstanding' amounts refer to the operational portfolio of the Bank created as a result of its banking activities, not the portion of the Balance Sheet managed by the Treasury.

The above definitions and limitation imposed on the operational gearing ratio have the dual purpose of allowing the Bank:

(i) to realistically assess the degree of effective commitment by each of its Shareholders; and
(ii) to expand its operations up to that point where it can assume coverage of its liabilities by the use of subscribed capital, after reasonably discounting for the risk of not being in full allocated the callable portion of equity capital by Shareholders with overdue obligations to the Bank.

While the institutional Gearing Ratio cannot be changed, the operational Gearing Ratio will be thus limited to 1:1 of the Bank's paid-in capital, reserves, surpluses and at most 100% of the callable capital. Such a limit will help in establishing the Bank's credit rating while allowing for ample operational leeway.

3.2 Total disbursed Equity Investments

According to Art. 15(3) of the Agreement, the amount of the Bank's disbursed equity investments shall never exceed an amount corresponding to its total unimpaired paid- in subscribed capital, surpluses and reserves.

3.3 Public and Private Sectors Risk Assessment Policy

Operationally, the Bank welcomes without preference, operations in, or involving, the private sector and the public sector.

Operations are assessed on their own merits, on the basis of, inter alia, their risk/return profile, economic viability, financial sustainability, development impact, and overall contribution to realization of the mission of the Bank.

Notwithstanding the above mentioned policy statement, in terms of risk assessment and exposure limits the Bank distinguishes between participation in the public sector and in the private sector.

3.4 Limits on Equity Investments

The Bank's overall operational portfolio limit with regards to equity investments shall not exceed 50% of the paid-up capital. The limit for single equity investments shall not exceed 3 % of the Bank's paid-in capital.

4. Portfolio diversification

The Bank's exposure policy is to diversify risk to the extent possible in order to minimize potential losses in the overall portfolio. The Bank has the difficult task to meet its strategic objectives while setting an appropriately balanced structure of its portfolio, controlling the risks and obtaining returns. The

combination of transactions in the portfolio should be chosen in such a way as to enable the Bank to achieve its objectives with minimum risk.

The Bank will therefore establish operational limits and guidelines for its loan, guarantee and equity investment commitments in any one country (country risk exposure limit) and to any single obligor (single obligor limit) or any single operation (project risk and operation limit). The operational limits are subject to revision. These limits have to take into consideration practices used by other financial institutions and will be reviewed by the Management Committee in the light of the Bank's experience. Changes to these limits will be implemented according to the procedures outlined in the section entitled "Purpose of Limits". The overall portfolio composition is measured at the end of each financial year. Updates will be presented by the Department of Risk Management to the Management Committee and to the Board of Directors on a quarterly basis.

5. Portfolio Review

The Operational Portfolio of the Bank is supervised and monitored regularly according to the Operations Cycle Policy and the procedural specifications of the Operations Manual.

When warranted, but at least twice a year, all operations in the portfolio are reviewed, evaluated, classified according to their risk and provisions are constituted, added or released, as appropriate. The Risk Asset Review process is conducted in accordance with the provisions of the Financial Policies and of the Classification, Measurement and Impairment Recognition Policy.

6. Country Risk

6.1 Description

The quality of the Bank's assets is affected in a significant measure by the institutional structure and the strength of institutions, quality of governance, legal framework, including also the rigor of their regulators and supervisors, as well as political and economic events in the countries of operation. Country risk assessment in this context relates essentially to the quality of the operating environment and ease of doing business, and the effects such factors have on a country's ability to service foreign and domestic obligations, as well as protect in both a physical and institutional manner the operating capabilities of an investment.

The Bank may, from time to time, be asked to assume risk in local currencies which are not internationally traded to any significant degree, or may not be freely convertible. There are two ways that the Bank can hedge against this kind of currency risk:

i) By ensuring that funds are borrowed by the Bank, lent to the obligor and repaid to the Bank in the same local currency. The foreign exchange and transfer/convertibility risk associated with interest payments is assumed by the Bank

ii) By denominating the respective exposure in local currency indexed to a reference freely convertible currency in which the Bank normally conducts its operational activity and in which its exposure is denominated. In this case the borrower assumes the exchange rate risk and the Bank assumes the transfer/convertibility risk of the member country where the operation is located.

In order to mitigate risk for certain operations, the Bank may require certain protection mechanisms, such as off-take agreements, escrow accounts, or buy-back agreements. Furthermore, and to the extent possible, the Bank shall seek to adequately secure its financial transactions. Given the Bank's regional role and expertise, the Bank will be in a strong position to suggest such arrangements.

6.2 Country Risk

Country risk is determined by the Bank's specialists evaluating quantitative and qualitative measures of risk. The Bank shall use the most reliable sources of information available. To the relevant extent, the Bank's assessments shall take into consideration the criteria used by similar IFIs, rating agencies, as well as reputable international research institutes.

6.3 Country Risk Limit

The country limits aim at preventing excessive risk concentration in one country. The limits are operational and apply to the total aggregate committed loans, guarantees, and equity investments, as defined in table "Operational Limits" at page 13. The country risk limits reflect risk diversification and not resource allocation.

The individual country risk limit of the Bank will never exceed 30% of planned commitments. This limit is calculated on the basis of the Bank's total BoD approved operations net of repayments and cancellations in the active portfolio.

Country risk is mainly a function of an operation's country of productive activity. Therefore, the owner/promoter/sponsor's country of registration/residence should not be a major factor in country risk evaluation, but shall be considered as a risk mitigant where appropriate.

Thus, the country risk that will be considered for pricing is mainly the one assigned to the country of realization of the operation (where the financed operation takes place), combined in a certain proportion and in special circumstances, to be determined internally by the Bank on a case-by-case basis, with the risk of the country of registration of the obligor (if different from the country where the operation is located), and/or the quality and provenance of security. It is important to note that a country's risk rating should be viewed as a determinant of pricing and overall risk exposure rather than willingness to operate in a market.

Disbursements generally count towards the ceiling of the country of realization of the investment that is the country in which the operation is registered.

The Bank's Board of Directors will be informed about the country exposures at least twice per year. Information on the portfolio developments by country will be provided quarterly, while a full portfolio analysis will be submitted annually. Changes to these limits will be implemented according to the procedures outlined in the section entitled "Purpose of Limits".

7. Sector Risk

7.1 Description

In order to achieve its development aims, the Bank will establish a sector portfolio investment strategy in conformity with its priorities and objectives. Each operation is evaluated on its own merit, including the risks inherent to the particular sector of economic activity.

Sector development is very dynamic and is prone to fluctuations due to international factors as well as regional and national ones. Therefore, the Bank will continuously monitor the sectoral concentration of its loan, guarantees and equity investments. However, sector diversification is possible more on the regional level and less on the country level.

Due to the fact that the Bank may nevertheless have a high risk due to excessive concentration of exposure, sector limits may be established by the Management Committee following a recommendation to this effect made by the Department of Risk Management.

8. Single Obligor Risk

8.1 Description

One of the fundamental ways to diversify credit risk is to ensure no single borrower is permitted more than a "reasonable" amount of financing as related to the Bank's capital. Furthermore, were the Bank to have a high proportion of relatively large single exposures relative to the overall portfolio, this could result in perceptions of a highly concentrated portfolio and thus leave the Bank be more exposed to risk than if it were to have a more widely diversified portfolio.

The definition of the single obligor limit is the maximum amount exposure, which the Bank will extend to any one borrower or group of borrowers, which are majority owned or effectively controlled by a single entity. Furthermore, if a project has multiple participants/obligors, disbursement will count proportionally against single obligor limits as calculated per participant.

8.2 Single Obligor Limits

The operational limit of Single Obligor exposure for any private sector operations shall be set at up to 10.0% of paid-in capital, reserves, and surpluses, as a matter of sound banking practices. This SOL should be reached only for operations which have high development impact, mandate fulfillment potential, and/or relevance for the Bank.

Public Sector operations comprise sovereign and non-sovereign operations:

I. Sovereign operations are operations where the Sovereign (including any instrumentality thereof properly authorized to commit the full faith and credit of the Sovereign) is a counterparty of the Bank either as direct obligor or as guarantor of the relevant obligation. For sovereign risk operations, this single obligor limit does not apply. The operational country ceiling remains the limit for each country.

II. Non-sovereign public sector operations are operations which provide Bank financing to:

(i) development institutions or governmental agencies - at national, regional, or local level - which are explicitly mandated by law to perform functions relating to the development of the economy (including such entities as development banks and eximbanks);

(ii) regional, or local, governments and municipalities of the country of operations (or operations guaranteed by them);

(iii) public utilities (i.e. utilities that are not operating autonomously in a competitive market environment and which are not subject to normal bankruptcy or insolvency law processes); or

(iv) other entities with a clear public mandate, established by a specific charter or legislation and not operating in a competitive environment due to legislative restrictions or the nature of the activity (e.g. natural monopolies).

For non-sovereign public sector operations the single obligor limit is set, as a general rule, at two (2) times the single obligor limit for private sector operations. For special circumstances of project finance and public infrastructure projects, the SOL applicable to the public sector will be raised to the maximum of 20% of paid-in capital, reserves, and surpluses. Nevertheless, exposures in excess of €120 million will be considered only in exceptional circumstances.

Guarantees of a quasi-sovereign nature offered by sub-national units of member countries, or sub (non)-sovereign guarantees offered by administrative units (e.g. municipalities) shall be considered on a case-by-case basis, but shall not be considered substitutes for sovereign guarantees.

In order to diversify risks in its equity investments, the Bank's committed equity investment to a single obligor must not exceed 3% of the Bank's paid-in capital.

Additionally, the Bank shall establish an aggregate limit for the first 5 single obligors in order to control portfolio concentration. The Bank shall establish an operational limit for the first five obligors of no more than 40% of the Bank's planned commitments (total BoD approved operations net of repayments and cancellations in the active portfolio).

These operational limits are effective from the date the present policy has been entered into force. Changes to these limits will be implemented according to the procedures outlined in the section entitled "Purpose of Limits".

9. Single Project Risk

9.1 Definition

The single project risk, and related single operation limit, is the maximum total loan, guarantee and equity investment, which the Bank will extend to any stand-alone operation. While the Bank may gradually establish a minimum size requirement per stand-alone operation, small value operations should be weighed on a case-by-case basis to ensure that the cost benefit ratio for the Bank remains favorable.

9.2 Single Operation Limit

Special purpose companies established for project purposes should be treated as obligors, and thus are subject to the single obligor limit. The single obligor limit applies cumulatively to the entire set of outstanding exposure to a client, irrespective of the financing instrument used. Thus, the single operation limit shall not exceed the single obligor limit.

However, this may prove problematic since the Bank will use a strict calculation of the single obligor limit that is likely to prove too low to be effective in the case of large- sized projects with significant mandate fulfillment content.

The Bank may address this issue by exchanging a higher project limit for guarantees against the operation via a graded system of mitigant acceptability. Acceptable mitigants include, but are not limited to, full sovereign guarantees, and the participation of other multilateral institutions. The acceptability of mitigants will be evaluated on a case-by-case basis.

For sovereign and sovereign guaranteed operations, the Single Operation Limit is set at two single obligor limits (2 SOL), in other words up to 20% of paid-in capital, reserves, and surpluses.

For private sector project finance and infrastructure operations, the single project/operation limit is established at 50% of total project cost, or long- term capital required by the operation, as appropriate, but in any event such exposure may not exceed the single obligor limit for private sector operations.

For public sector operations, the single operation exposure may cover up to 70% of project cost, but in any event such exposure may not exceed the single obligor limit for public sector operations.

These limits are applicable for limited recourse Project Finance operations.

Individual single operation limits for other instruments used in Corporate or Trade Finance operations are established for each type of instrument described in Part II of this document, Investment Policy.

The Bank's equity participation shall not exceed 33% of the total equity capital stock of the enterprise concerned, in conformity with the provisions of the Article 15 (2) of the Establishing Agreement. Exceptions are made in exceptional circumstances, specifically approved by the BoD. The desired equity participation is set in the range of 5% to 25% of the equity capital of the investee company.

The total amount to be disbursed by the Bank over the lifetime of an operation must still qualify under operational country limits. Changes to these limits will be implemented according to the procedures outlined in the section entitled "Purpose of Limits".

OPERATIONAL LIMITS

Category	Percentage	Capital
Gearing Ratio	100%	Paid-up capital, reserves, surpluses, the usable portion of the callable capital, and the amount of reserves and surpluses times the ratio of the Bank's usable portion of callable capital to the Bank's unimpaired paid-up capital.
Equity Investments	50%	Paid-up capital
Country Risk limit	30%	Planned commitments*)
Single obligor limit: - for private sector operations;	Up to 10% for high development impact, mandate fulfillment, and relevance for the Bank	For loans and guarantees: paid-in capital, reserves, and surpluses
- for public sector operations (non- sovereign and non-sovereign guaranteed);	Up to 20% but not more than €120 million, except in special circumstances	Paid-in capital, reserves, and surpluses
- for equity	3%	For equity: paid-in capital
Aggregate of first 5 Obligors	40%	Planned commitments*)
Single operation limit for sovereign and sovereign guaranteed public sector operations	Two SOLs for private sector operations, namely up to 20%	Paid-in capital, reserves, and surpluses
Single operation limit	Project Finance: For private sector operations Up to 50% of project cost, or long-term capital requirement, as appropriate. For public sector operations, up to 70% of project cost. This limit applies cumulatively to debt and equity financing, and guarantees if appropriate, that constitute the financing package and may not be greater than the SOL for private/public sector, as appropriate. Equity Investment: Up to 33% of the equity capital of the enterprise concerned. Preferred is between 5 to 25%. Corporate finance: Maximum 100% of financing request, depending on the type of instrument, up to SOL. Trade Finance: Maximum 100% of the value of transaction, depending on the type of financing instrument and circumstances, up to SOL.	

*) This limit is calculated on the basis of the total BoD approved operations net of repayments and cancellations in the active portfolio.

PART II

INVESTMENT POLICY

1. Objectives

The bases for Part II of this document are the Establishing Agreement of BSTDB, the Rules and Regulations for Financing Projects and Commercial Activities by BSTDB (approved by the Board of Governors), and the Financial Policies (approved by the BoD).

These Investment Policies may be, if deemed necessary, further detailed in operational documents to be issued internally.

The Bank has three main lines of business: Project Finance, Corporate Finance and Trade Finance. For financing operations the Bank utilizes a number of instruments/products either independently or concurrently in structured operations. Furthermore, the Bank may act either as a sole financier, or participate in a multitude of ways in cofinancing arrangements.

The purpose of this section is to provide the basic guidelines for Bank's products, i.e. loans, equity investments, guarantees, and special products. The Bank will gradually develop further its product line as it develops specific expertise, with a view to acting proactively in order to meet evolving market demand. These guidelines set up the general terms under which the Bank will conduct its operations (excluding treasury operations described in Treasury Policies).

The Bank offers its clients a wide range of financial products, including: loans, equity investments, guarantees, leasing, discounting, forfeiting and other special products such as underwriting commitments and stand-alone risk management products to be developed by the Bank further. The choice of instruments is determined primarily by the requirements of the Bank's clients and their operations in consistency with the Bank's policy.

The terms of the Bank's products are tailored to meet the specific requirements of each client and operation and may be adjusted throughout the term of the operation. Such adjustment may, if so provided in the original documentation, extend to the conversion of one product type to another during the life of an operation.

2. Loans

The Bank offers a wide range of loans, which enables the Bank to respond flexibly and effectively to the diverse needs of its clients and to address their specific financial risk.[3] The Bank tailors loans to specific financial requirements of its clients, including project, corporate and trade transactions, and affords its clients the benefit of the most sophisticated financial techniques available in the international financial markets.

The Bank may provide (desirably in EUR) customized loan features in order to meet client currency and interest rate risk preferences without subjecting itself to higher risk or additional cost. The Bank charges an adequate structure of interest, fees and commissions to compensate it for costs and risks incurred in providing these services. The structure of fees and charges associated with these services are designed to compensate the Bank for hedging costs and administrative expenses required to provide such features. The basis for providing a loan is the rigor of the cash flows of the project and the ability of the obligor to repay that loan over the agreed period. Loans could be committed in one or more currency tranches.

The Bank will offer a range of short to long-term loan products on both variable and fixed bases. The Bank's loans can be denominated in any currency or combination of currencies, including local currencies,

[3] Financial risk includes interest rate, foreign exchange and commodity risks

in which the Bank is able to fund itself either directly or through currency swaps. Loan convertibility in terms of currency and interest rate configuration is possible, provided that conversion from one loan configuration to another and unwinding costs are subject to a conversion fee.

The Bank's loan products will have various, tailored, options and features which have two principal objectives: (i) to provide borrowers with the flexibility to meet their specific needs, and (ii) to give the Bank a strong competitive position in the market.

2.1 Exposure

The Bank provides loans to private and public sector entities. The Bank will pay due regard to the quality, commitment and experience of the management / owners of the final beneficiaries (effective users of funds) in its exposure to both sovereign and non-sovereign-risk public and private entities.

Loans are normally to be secured, although the Bank may accept an unsecured position where this is judged to be consistent with sound banking principles. The acceptable security may include but is not limited to collateral, guarantees, pledges or any other security from shareholders or third parties. For determination of applicable security in Bank financed operations shall be followed the provisions of the Security Guidelines for BSTDB Banking Operations. The security will help to protect not only debt service but also commit security providers to continued supply of management, technology, and equipment, or completion of the project.

Acceptable debt structures must take into account the expected cash flows, an adequate contribution made at the risk of the promoters and security for the repayment obligations, employing varied techniques for reducing the risk to the lender.

Loan covenants must be considered which will ensure the maintenance of a balanced financial structure. Appropriate actions are to be taken if borrower breaches loan covenants, including interrupting disbursement, loan acceleration, cancellation, restructuring, or instituting legal procedures. In cases of deterioration of asset quality and/or of delinquency, the Bank shall make use of the procedures presented in the Financial Policies.

2.2 Currencies

Loans extended by the Bank may be denominated in any currency, or a combination of currencies in which the Bank is able to fund itself either directly or through currency swaps. The Bank considers as appropriate extension of the loans denominated in local currencies of member countries where: (i) the Bank can raise term funds in local currency, and (ii) the local currency is not subject to substantial exchange restrictions and controls.

Fund raising in local currencies should be encouraged only if the cost of funds is lower than the cost of funding in the reference hard currency plus the expected rate of depreciation of the local currency against the reference currency over the repayment period of the loan. In cases where funding in local currencies is not available, or the Bank considers costs and/or risks associated with this operation unacceptably high, lending in local currency may be used with repayment terms and conditions (repayment of principal amount, interest rate payments, fees and commissions) indexed to the reference currency in which the Bank either funds itself or holds its equity, reserves and surpluses.

For each portion of the loan denominated in a distinct currency, the applicable terms and conditions will be established separately, to reflect: (i) cost of funding; (ii) market conditions; (iii) administrative cost; and (iv) risks.

The Bank may raise funding in a range of currencies by means including, but not limited to: loans from banks, public bond issue, private placements, and commercial paper issues in the

required currency. The Bank may also raise funding in a required currency by employing cross-currency swaps to convert funding raised in other currencies to the desired currency funding for the appropriate period.

2.3 Repayment and Tenors

Most loans will be medium to long term, i.e. outstanding for more than one year. Normally, these loans will be serviced from the cash flow generated by the operation over a number of years. The longer the time to full repayment, the greater the uncertainty those favorable conditions for repayment will continue. For this reason the Bank establishes a guideline that the final maturity of its loans normally will not exceed 10 years. Consideration will be given to exceeding 10 years maturity for operations that highly contribute to the mission of the Bank, the cash-flow profile warrants this, and the risks are not likely to increase over time.

It is the Bank's policy to generally price loans on a variable rate basis; nevertheless, in particular when either the financing instrument or the Bank needs so require, the Bank may offer fixed interest loans. Variable interest rate payments must be made regularly (normally quarterly or semia nnually) on interest resetting dates. Fixed rate loan interest payments should normally be made semi-annually.

In the case of on-lending, the Bank should ensure that the conditions imposed upon the ultimate borrower are not more favorable than to the direct borrower and that the financial strength of the direct borrower is not unduly weakened.

2.4 Principles of Loan Pricing

The Bank's Financial Policies stipulate that pricing must be determined taking into account cost of capital employed, level of risks involved, administration and operating costs incurred in generating, implementing and monitoring a loan, as well as income requirements.

Pricing reflects both country risk and the perceived project-specific risk, depending on particular financial structure of the operation, its financial strength, parties and technologies involved, quality of security available, tenor and sector of economic activity. All operations supported by the Bank must have a clearly defined obligor.

Generally, for a Project Finance operation, a project should provide a return of at least 2% to promoters, and full coverage of the aggregate of the financing and administrative costs to the Bank.

Pricing of the Bank's products entails three main components including: base rate, margins, commissions and fees.

A. Base Rate

The base rate component is linked to either (i) LIBOR or Euribor for the relevant currency, or (ii) the fixed rate equivalent of Libor or Euribor for the life of the loan, as determined by the Bank with reference to the interest rate swap market. Upon a client request the Bank may also provide caps, floors or collars applicable to the chosen Libor or Euribor floating rate. For currencies not actively traded internationally and for which no benchmark rate is available, a relevant rate will be determined by the Bank based on its cost of funds for the repayment profile of the operation.

B. Margins

a) *Country risk* margin component is derived from the assessment of country risk described in

more details in Part I of this document. The country risk margin ranges from zero to two percent (2%) per annum.

b) *Project risk* is determined depending on the type and magnitude of risk, on the basis of BoD approved methodology. A number of factors relating to these risks are considered in arriving at the price, including:

i. size of operation, grace period, and final maturity;
ii. market perception of the current or comparable financing;
iii. financial sustainability and economic viability;
iv. technical feasibility;
v. market conditions;
vi. operating environment.

The range for project risk margins is from zero (0%) to two percent (2%) per annum.

The total risk margin for a standard 1 year loan can range from zero (0%) to four percent (4%) per annum, or higher in well justified circumstances.

A term risk component may be included in the risk margin over the combined country and project risk margin for a standard 1year loan. Thus, 5 basis points may be added for each additional year of maturity.

The country, project and term risk components are combined to yield one single measure of risk margin.

c) *Cost of Funds* - pricing will include a margin aimed as compensation for the aggregate cost of funds, where the borrowed funds are considered at their value weighted average margin above the relevant base rate benchmark, and the shareholder funds are taken at zero cost above the benchmark base rate.

d) *Allowance for administrative costs*.

e) *Contractual spread* - In addition, for every operation the Bank will charge an additional one quarter of one percent (0.25%) contractual spread (profit margin) to: (i) compensate shareholders for their funds and support provided to the Bank; and (ii) provide a minimum profit for the Bank.

C. Commissions & Fees

Fees and commissions may be charged consistent with principles set out in the Bank's Financial Policies. This includes without limiting, front-end commission as well as commitment charges, prepayment and conversion fees. This fees, commissions and charges may fluctuate within a range or vary on a case by case basis. They provide partial recovery of operational, administrative and other costs the Bank has made in granting the loan and contribute to the building of the Bank's reserves and surpluses. In specific cases the Bank may charge unwinding and restructuring fees, which will reflect the costs associated with such operations and which the Bank recovers from the obligor.

Front-end commissions are generally charged and payable at the time of signing but not later than first disbursement. They typically vary from one half of one percent (0.5%) to one percent (1%) and are typically payable in a single installment. The Bank will consider applying the lower commissions in cases of operations with high development and regional cooperation impact. Refunds may be offered to obligors under specific circumstances. The Bank is entitled to settle the payment of commissions by deducting them form the first disbursement.

Commitment charges are intended to compensate the Bank for the cost of carrying liquidity, and are payable by the client on the committed but undrawn part of the facility. They vary typically from 0.25 percent to 1.5 percent, or higher if warranted by circumstances, for both variable rate loans and fixed rate loans. To the extent possible they cover the difference between the cost of funds and the return on liquidity. Commitment charges should typically begin to accrue immediately after the signing of loan documentation (coming into force), but not later than the date of the first disbursement, for the portion committed and made available but not withdrawn according to the disbursement schedule, if any.

Prepayment fees are charged to offset expenses incurred by the Bank and compensate it for opportunity costs, and are included in a loan agreement.

Unwinding costs incurred by the Bank are charged to cover the funding costs associated with such events as prepayment and cancellations, payment defaults, loan accelerations or conversions.

Convertibility from one loan configuration to another, in terms of currency and interest rate configuration, is possible provided that costs are recoverable by the Bank subject to a conversion fee. Additional optional loan features depend on market funding and swap market opportunity available to the Bank.

Depending on the specificities of each individual transaction other fees and commissions may be applicable; in addition the Bank shall seek reimbursement from the obligor for costs incurred in direct relation to the financed operation.

The application of the Bank's pricing methodology, as established in the Financial Policies, in the case of individual operations is delegated to Management in order to provide for consistent application of pricing principles to each individual operation and to give the Bank adequate flexibility in negotiations. The Board supervisory function is exercised through reviews, in conformity with the principles set forward in the Financial Policies. Pricing information and documentation for specific loan transactions is available only to the parties involved in this transaction.

2.5 Types of Loans

A. *Project Finance*

All project loans (sovereign and non-sovereign risk) made by the Bank will be fully assessed by the Bank on the aspects of risk / return, repayment prospects and the capacities of the borrowers' guarantors. This has special significance for operations involving external finance. Capacity to repay on a timely basis is the key risk factor for co-financiers who do not have the Bank's relationships with the borrowing member country.

The competence and ability of public executing agencies to carry out projects is also key factor of analysis. Other factors include an evaluation of the procurement procedures used by the borrower, an economic analysis including regional cooperation and development impact, economic viability and financial sustainability of the project, and environmental analysis.

Projects can vary substantially in the expected financial and economic rates of return depending upon the sectors in which they are made and that some projects are not expected to generate immediate financial returns.

The Bank may provide loans for entirely new ventures or the expansion or modernization of existing operations. Usually the Bank will be repaid from the cash flow of the venture. To justify the feasibility of the project, projections of cash flow and balance sheets need to be provided by

borrowers in accordance with the requirements established by the Bank. The projections should include a statement of each operating assumption. Financial projection shall consider the sensitivity of the cash flows to alterations in the operating assumptions.

In exceptional circumstances the Bank may provide loans with maturity longer than 10 years. This would typically be the case for mandate enhancing operations with strong development and/or cooperation impact, such as infrastructure projects which require heavy upfront investment and construction time, and which start to pay significant dividends- either directly financially or more broadly economically- after a considerable number of years. It is recommended that the Bank participate in financing projects with maturity longer than 10 years only in cases where there can be a clear and demonstrable development impact for the member countries, projects contribute to the economic growth of the economies in the region and promote regional cooperation and economic integration. These benefits should be substantial and measurable. Such projects have terms and conditions negotiated usually with the lead manager of the financing syndicate. Due to its size, the Bank is not normally in a position to lead/manage such complex financing operations. It is therefore recommended that the Bank participate at a level with which it feels comfortable within the overall exposure limits for project, single obligor or country, as appropriate. As a rule of thumb, the Bank may wish to consider limiting very long- term lending (maturity longer than 10 years) to within 10 percent of its operational portfolio of BoD approved operations.

A number of cross-country projects involving or benefiting the Bank’s member countries require significant amounts of funds, which are usually provided by a number of financiers (multilateral development agencies and international financial institutions, official development funding provided by governments of non-member countries, funds allocated by national authorities of member countries, investment banks, commercial banks and other private financiers). These projects tend to be complex operations, but they often are of high importance for the Region, they promote cooperation and economic integration in the Black Sea Region, and their relevance may extend beyond the BSEC Region, thus providing additional strategic benefits to Member Countries; they thus contribute strongly to the fulfillment of the mission of the Bank.

The Bank may act either as a member of a financing syndicate, or as a separate financier. Where the Bank considers it appropriate to provide financing separately from the main financing syndicate, it may do so either for the general purposes of the project, or it may identify a portion or a sub-section of the project, largely independent from the overall project, which it may finance wholly or partly. The Bank should be highly selective in terms of participating in syndications. The involvement of BSTDB should preferably be from an early stage of project development to be able to contribute to the structure of the deal. The pertinent collective decision-making requirements should be highlighted, and control in decision-making process should be targeted. To the extent possible, should be avoided situations where the Bank is invited by private financiers to take a remaining part out of a settled deal at the last moment.

In the case of complex project finance operations, where a number of financiers take part in a syndicated loan that has a high value and maturity extends beyond 10 years, sovereign guarantees of the state/states involved in the project should normally be required. Where sovereign guarantees are not available, a strong security should be sought preference being given to readily available assets whose realizable market value is stable and can be easily assessed.

For projects that are within the financing capability of the Bank and have a maturity of less than 10 years the Bank should not normally seek a sovereign guarantee, but would make all necessary efforts to secure the loan adequately.

As a preferred creditor, the Bank, when participating in the financing as part of a syndicate, should at a minimum accept the same security offered to other financiers, and clear liens should be determined from the onset, which are identifiable, traceable, realizable and provide reasonable

comfort that they consistently cover the value of the remaining principal and interest due. In cases where the Bank acts as co-financier, its share of the overall security provided to the lenders should be proportionate to its share of financing and should benefit from similar conditions with those offered to the other financiers, except in cases where application of the Bank's preferred creditor status gives it preference that does not extend to all lenders. In other words, the Bank financing should be provided on terms and conditions that should be at least at par with those offered to the other financiers.

The grace period may extend to a maximum number of years not exceeding a third of the loan maturity. The maturity of the loan and grace period should however be determined with due consideration being given to factors such as: the useful life of project; revenue generation capacity of the project; time expected to elapse before the project generates profits; solidity, marketability and reliability of the security provided.

The availability period should be closely related to the technical specifications for project execution, but should normally not exceed five years. In case there are specific sub-projects identified that have agreed disbursement and repayment schedules, the availability period should be thought of as the one described by the disbursement schedule if any, and should not affect the specific grace period. To the extent possible, payments/disbursements should be made against documents and directly to the provider of goods, works and services.

When acting as a co-financier in large value projects the Bank should earmark for itself a portion of each repayment proportionate to its share of the financing. The availability term will normally be established according to the project requirements and in consistency with the grace period. Principal repayments should commence as soon as positive cash flow from the project is available. Principal repayments will usually be made in equal installments with the same frequency and at the same time as interest payments, although customized repayment schedules may be considered on a case by case basis.

B. *Corporate Loans*

Corporate loans are provided by the Bank to companies (private entities, public/quasi-public institutions and/or agencies, financial institutions) in order to cover expenses such as, among others, purchasing equipment and inventories, acquiring other businesses, paying suppliers of utilities and meeting payrolls.

In the general sense their coverage may be expanded to include all Balance-Sheet facilities. However, in view of the mandate of the Bank, not all of the expenditures - for which corporate loans are typically used - are eligible for BSTDB financing; priority will be given to promoting institutional development, capacity building, financial and operational strengthening, increased competitiveness, expansion, modernization and diversification of activity.

The Bank should not provide financing for:

a. Brokered projects;
b. Restructuring in distressed situations (excepting distressed assets of BSTDB);
c. General purpose loans with no clear mapping of the use of the proceeds of the loan;
d. Debt refinancing, except in cases where:
    (i) Not more than 30 % of the facility amount the Bank considers to provide shall be used for the purpose of debt refinancing, and
    (ii) There is clear mapping of the use of the proceeds of the rest of the facility amount the Bank is considering to provide.

The Bank may provide project financing for bridge financing loans of up to one year maturity.

The Bank is a development institution that must ensure that Bank funds are used to create value

for the economies of Member Countries.

Eligible types of corporate loans

Investment loans, also known as term business loans, refer to the provision of loans for the acquisition of equipment, modernization of plant and structures, acquisition of new technologies and other related expenditures. It involves the provision of medium-term (one to five years) funding to eligible manufacturing clients for the specific purpose of purchasing capital equipment for the upgrade and modernization of existing manufacturing and production facilities. Borrowers eligible for such financing would be export oriented.

The imports of capital equipment would not be restricted based on their origin. Following the Bank's *Procurement Principles and Rules*, the importing private sector company would purchase equipment fit for the intended purpose at a fair market price, regardless of where the equipment originates. This approach would help to ensure that manufacturers get the equipment required to maximize competitive positions, resulting in greater exports, job creation and hard-currency revenue.

To the extent possible the Bank will seek to obtain refinancing from official export credit and development agencies of the countries from where the capital equipment subject to the transaction originates. The Bank may finance up to 85% of the value of the transaction, but only up to the single obligor limit. Provision of the product should only be considered for capital equipment, not consumer goods or services.

Clear demonstration should be required that as a result of Bank involvement, export performance will improve. This would have an evident developmental benefit in the country hosting the firm, and it would also facilitate regional cooperation to the extent that a portion of the exports goes to other BSEC states. Additional favorable features include that the equipment introduce new technology or techniques into the Region, that it possess the potential for demonstration effects in other BSEC countries and that it helps in improving environmental protection. A further positive feature would be instances where co-financiers are involved, thus permitting additional funds to be mobilized.

Usually the loan is provided as a lump sum (disbursed at once after the signing of the loan agreement) and is repaid either in installments or as one single "bullet" payment at the end of the loan period. However, the loan may be disbursed in tranches as payment needs arise. Disbursements may be made to the borrower, or payments may be made directly to the supplier of the equipment contracted. In all cases, the Bank must keep track of the use of the proceeds of the loan and must ensure that payments are made only for eligible expenditures, as stated in the loan agreement. This type of loans is usually secured by fixed assets (plant or equipment) owned by the borrower, or by the shareholders of the borrower. These assets will not be pledged to other creditors and proper insurance may be obtained and pledged in favor of the Bank.

Construction Financing is a form of short to medium-term financing used to support construction of permanent structures (office buildings, houses, factories). The proceeds of the loan are used to buy or lease construction equipment, purchase building materials, develop land, and pay workers. The proceeds of the loan are not used for the operation of the facility whose construction was financed. Repayment is usually made at the end of the construction phase, and only in exceptional cases from the proceeds of the operation of the project.

Mezzanine Financing refers to the provision of medium-term unsecured debt, normally for the expansion and operation of a business. This type of financing usually includes a warrant or an agreed form of profit-sharing agreement, as opposed to the normal interest charged by a creditor, in order to allow the financier to participate in sharing the benefits according, and proportional, to the risks it takes. Mezzanine financing takes the form of subordinated debt, and is therefore

senior to equity and quasi-equity but junior to other more traditional forms of debt. It is often used in conjunction with the acquisition of a business in support of its development, restructuring or modernization, or with the provision of additional financing by a venture capital firm.

Financing of Acquisitions of Other Businesses are loans provided to investors from Member Countries to purchase, modernize, restructure, or expand production capacity of a firm in any of the Member Countries. The purpose of the facility is to promote cross-country investments and economic integration of the countries in the Black Sea region. The Bank must obtain a secured creditor position backed by security, preferably fixed assets free of any claim and properly insured, whose realizable value covers at least the value of the principal of the loan. The use of the proceeds of the loan for acquisition of assets in countries that are not members of BSTDB is forbidden. The Bank may finance up to 100% of the expenditure needs of the client, within the risk exposure limits in force.

Working Capital loans refer to the provision of financing to companies for the primary purpose of meeting recurring, or operational, expenditures, rather than for purposes of investment, or capital equipment purchase. The eligible purchases are represented by inventories of raw materials and intermediate goods, utilities, salary, etc. Usually such loans are secured by accounts receivable and inventories. Such loans normally will not be offered by the Bank on a stand-alone basis, but only in conjunction with, or as a portion of, a loan structure that centers on another form of eligible financing. Working capital should normally be limited to a maximum of 30% of the total financing provided by the Bank to a client in a particular financing package.

This product should be offered directly to the borrowing firm. The Bank may finance up to 100% of the expenditure needs of the client, within the risk exposure limits in force. The whole range of security and covenant arrangements may be used, and loans may be secured or unsecured, depending on the quality of the borrower and the risk mitigants that may be available on a case-by-case basis. The Bank should have the ability to renew, accelerate, restructure or recall the loan, depending on the performance of the borrower.

Disbursement may be effected upfront, following signing and meeting of any conditions, as agreed in the loan agreement, or may take place on request. Care needs to be taken to ensure that the borrower conforms to Bank procurement rules in using the proceeds of the funds (e.g. the funds should not facilitate acquisition of assets outside the BSEC Region). Sufficient and acceptable documentation, to the satisfaction of the Bank, should be provided by the client, which would demonstrate that the proceeds of the loan are used for eligible expenditures.

Rationale for Offering the Product

In the course of its operations, the Bank has encountered a higher than expected demand from Member Country firms for medium term (one to five year) corporate loans which is not currently satisfied by local banks.

Therefore, (i) recognition of the requirement for medium-term financing for modernization and upgrading, (ii) perceptions of country risks, and (iii) the unwillingness/inability of local commercial banks to meet the growing demand of firms, combine to provide an opportunity for the Bank to meet a real market need. It appears therefore that the Bank is a well suited candidate to provide financing since, as an international financial institution, it is able to take on elements of risk to which private operators are averse.

Any operation should be considered on its financial merits and its 'bankability', but also for its development impact. Therefore, there exists a niche to be filled by the Bank, and the provision of medium term loans to medium and large size locally owned firms is a useful instrument for this purpose.

Recommendations and Guidelines for Use of Corporate Loans

Corporate loans should be offered for periods not exceeding five years, although in well-justified cases may extend to seven years. The minimum size of the loan, for cost-effectiveness reasons, should normally be EUR 3 million, or its equivalent in another acceptable currency. Exceptions for corporate loan operations in small shareholder countries are possible, but would need to (i) achieve a minimum level of profitability and (ii) be justified persuasively.

The product should be flexible to accommodate the needs of the client, but at all times it must preserve the interests of the Bank. Given the nature of this product, it is inherently likely to contribute more weakly to regional cooperation than other types of financing that the Bank may provide, such as project financing. Therefore, it is important that the benefits be clearly identified. These should include the following: (i) support for the development of the economy(ies) of Member Countries,
(ii) development of strategic relationships with important clients that may lead to greater business opportunities for the Bank, (iii) help in mobilizing additional resources for the benefit of Member Country firms, and (iv) additionally identified benefits, such as helping to modernize or restructure production facilities, increase market presence, etc., will be considered a plus.

C. *Credit Lines*

Description of Credit Lines

Credit lines have the purpose to provide selected banks with short to medium-term capital not available in the market and to encourage establishment of long term relationship between these banks and their clients in particular for trade finance operations and provision of medium term financing to SMEs. Only financial institutions being authorized by BSTDB as financial intermediaries are eligible to participate as borrowers for on-lending.

Financing is normally to be provided in the form of revolving funds but may also be in the form of back-to back facilities or bullet loans through intermediary/client financial institutions incorporated in the respective member country, with an acceptable branch network, prior good quality experience in trade finance, leasing or SME financing, controlled by local and/or regional interests, when possible. The credit line shall normally have a maturity of 3 to 7 years.

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.

Sub-loans are to be provided on commercial basis terms. The Bank should not be generally 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.

In order to be eligible for financing, sub-borrowers must be privately owned legal entities, which i) should have adequate financial standing, ii) can generate sufficient cash-flow to cover loan repayment, iii) should not have overdue obligations to budgets and/or banks, iv) should have market demand for their products, and v) should have sound management and good operations and financial management skills to profitably run the business.

The participating bank will verify these by requiring:

- financial and business information on owners/partners of the company;
- financial statements and cash flow for the last three years;
- contracts, orders or other acceptable documentation to justify output levels consistent with the financing requirements; and
- security in the form of pledges, mortgages, etc. as appropriate.

The debt capacity of the applicant sub-borrower is analyzed by the intermediary/client financial institution before loans are approved.

The Bank establishes the criteria for the appraisal and selection of financial institutions as per the Guidelines for the Appraisal and Selection of Financial Intermediaries and the procedures for such appraisal as per the Operations Cycle Policy. The disbursements to the financial intermediaries will be made in accordance with the provisions of the loan agreements with BSTDB, the Operations Cycle Policy and the Operations Manual. Additionally, the local participating bank will be required to provide information according to the Bank's Guidelines for the Appraisal and Selection of Financial Intermediaries. The loan agreements with the BSTDB shall encompass specific performance criteria by which the BSTDB can verify that loans are being used for the agreed purposes.

Sub-loans are usually available with maturities of a maximum of three to five years and grace period of up to 12 months, or in certain well justified cases of up to 24 months at a maximum. Their maturity cannot exceed the remaining time to maturity of the credit line. The funds provided will have to be used by the sub-borrowers in strict accordance with the original stated purpose.

The Bank, as a rule, should not be involved in the details of the approval process of sub-loans, reserving oversight for trade financing or 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.

Requirements for Use of Credit Lines

The Bank will work with selected financial intermediaries in countries of operations where such delegation of responsibility assists the Bank in serving a market segment more efficiently or effectively than the Bank might be able to do directly. In most cases, this would mean that intermediaries for both credit and equity would be those better able to reach and assist target clients mainly including small and medium size enterprises in these countries, but other means may be appropriate for such channels as well.

As a general rule the Bank will normally limit its use of financial intermediaries for on-lending purposes to situations where it is costly or practically not feasible to provide the effective assistance to the final borrowers directly, to process credit application and loan documentation and to administrate the credit portfolio.

Exposure as a Lender and Investor

Since exposure will be to the intermediary/client itself and through it to the credit quality of its portfolio, intermediaries/clients will have to have a track record of successful lending in these or similar markets and with similar clientele, as determined by analysis of their existing portfolios, their internal credit policies, controls and procedures. Successfulness of the previous experience with other IFIs will be sought. Where new branches or operations are involved, the commitment of head office or similar management of the supervision of the branches or business will be critical.

It will be normal to require the intermediary/client to assume a portion of the credit risk on each transaction. The Bank may require that it approves, or provides no objection, on each loan or equity commitment or commitments above specified limits or in case of other defined circumstances.

D. *Bonds*

Purpose

This section provides guidelines only for bond investments made by the Banking Division as part of the Bank's Operations Portfolio).

The Bank may invest in financial instruments issued by the Member States' central, regional, and local government, municipalities, government agencies and instrumentalities thereof, or by legally established financial institutions and non- financial corporations operating in Member States, where the country risk is predominantly that of a BSTDB Member State. The total size of investments in Member States bonds that are part of the Bank's Operations Portfolio is limited to 10% of the size of the Bank's planned commitments (total BoD approved operations net of repayments and cancelations in the active portfolio of loans, equity and guarantees).

The principal objective of making such investments is to provide increased financial assistance to Member States while generating income for the Bank, commensurate with the risk of acquired assets, as well to support the borrowers' development programs. These operations are simultaneously risk exposures and resource allocations that add to ordinary banking operations and thus fall under the aggregate country limit for operations.

Principles

The basic principles to be observed in conducting such investment operations are:

a) Particular emphasis is placed on purchasing debt securities on the primary market, normally at the request of the issuing organization, when traditional lending activity fails to meet budgeted targets, and there is clear indication of mandate fulfilment, such as:

- increasing market liquidity,
- promoting Member States within the investor community,
- supporting development of capital markets,
- assisting diversification of sources of funding for clients,
- supporting the borrowers' development, especially those related to capital expenditure.

b) Until such time as the Board of Governors amends its decision on the matter, for sovereign and sovereign guaranteed public sector issuers, it should be acknowledged and clearly stated a priori that the Bank's preferred creditor status is applicable, as a precondition for the Bank's participation.

c) Debt securities should preferably be denominated in USD, EUR or other liquid currency. Investment in securities denominated in Member State currencies may occur when funding in Member States' currency is possible and financially reasonable (e.g. there is an adequate level and depth of trading in financial markets, or cost-effective hedging is available)

d) The Bank to potentially act as underwriter/guarantor and purchaser of new issues

e) Treasury provides support with interest rate and currency risk management, trade execution, market research etc. as requested

f) Investments should, in principle, be held to maturity or until such time as divestment is deemed appropriate by the Bank.

g) Such investment operations shall be subject to the Bank's pricing methodology. Market developments should be continuously monitored to promptly react when there are signs of imminent change in the value of securities.

Credit Appraisal and Approval

Each transaction requires approval from the Credit Committee and the Board of Directors. The process for appraisal and approval is patterned on the expedited procedures of the BoD approved Operations Cycle Policy, with a pre-approval stage by the BoD on the basis of preliminary due-diligence conducted prior to having full knowledge of the precise details of the transaction.

a) Credit Appraisal Criteria

- For non-sovereign Member-State issuers, the credit criteria will be similar to the criteria for lending unsecured
- The issuing corporate should have either an international rating and/or internal Bank rating of no less than (BB-) from Fitch/S&P or Ba3 from Moody's or a rating equivalent to this and acceptable to the Bank.
- The issuing corporate should have an established borrowing history with at least reputable local banks
- The issuing corporate should be free of reputational risk and potentially damaging litigation. Due-diligence of counterparts to purchases and sales of issues should take into account the Bank's Anti-Fraud Corruption and Money Laundering Policy and Know- Your-Customer Procedures.
- There should be envisaged the possibility of trading on a recognized, and acceptable to the Bank, secondary market for the security
- Corporates that are government-owned or controlled shall be treated as private sector entities for the purposes of this policy, unless an explicit sovereign guarantee against the risk of the corporate is issued by an authorized government agency/ministry. In the latter case, the instrument should be treated as a sovereign obligation for credit risk purposes. (see Section D. Principles. bullet point B. above.)
- All credit appraisal criteria and process for approving regular banking operations shall apply to investing in Member State bonds.

Guidelines for Risk Management and Control

a. Record keeping/Audit trail

A detailed list/ summary of Member State bonds purchased/held should be in place and up-to-date (in the Bank's main reporting database- currently SAP) including the following details:

- For all purchases/sales of bonds: correspondent institution, amount, rate, date originated, date matured and collateral, if any required.
- Account numbers used for recording the purchase/sale of each bond in the General Ledger.
- Reference number of the selling bank's/institution's statement and/or confirmation.

b. Accounting/ Financial Reporting
Accounting policy should be clear as to which Member State bonds are recorded on cash or accrual basis, whether the Effective Interest Rate is used, and whether they are marked-to-market.

As such, these bonds are classified at amortized costs and considered under the business model as "Holding to collect" contractual cash flows until maturity.

In case one of the following, or similar, events occur, the operation should be brought to the attention of the Credit Committee for review:

i. The issuer doesn't meet the criteria for investment anymore (e.g. rating downgraded, or negative outlook, etc.)
ii. The market conditions for the security deteriorated substantially (e.g. liquidity decreased by half compared to post-purchase time, buy-sell spread widened to more than 2% of par value, etc.

3. Guarantees

3.1 Description

By the Establishing Agreement the Bank is empowered to guarantee as primary or secondary obligor, loans for economic development projects or programs. The Bank may provide full risk financial guarantee or (i) partial guarantee, where it provides all inclusive cover for a portion of debt service, or (ii) partial risk specific guarantees, where it covers specific risk events for all or part of the debt service. The guarantees can be provided either on conditional or unconditional basis.

Guarantees are one of the most important instruments available to the Bank to stimulate credit and capital markets in the region, mobilize additional capital, encourage the capital investments from outside the region and provide facilities otherwise unavailable on reasonable terms. Operations involving guarantees are appraised, processed and supervised in the same manner as those involving direct credit extensions and are subject to the same limits and requirements.

Definition

A Guarantee is a contract through which the guarantor undertakes to carry out the obligation of its client (guaranteed/principal) owed to the beneficiary, or to compensate the beneficiary for a specific liability of its client, in case the conditions that trigger the call on the guarantee are met, or at the demand of the beneficiary, depending on the stipulations of the contract. Guarantees do not provide a complete procedure for effecting payments or granting credit. Guarantees are off balance sheet obligations of the issuer, known also as "credits by signature".

The guarantee obligation is secondary to the primary obligation of the entity whose performance has been guaranteed. The obligation is most of the times irrevocable and obligatory where and when the conditions stated in the guarantee contract are met. On most occasions, the entity in whose favor the guarantee has been issued has to prove to the guarantor that default has occurred, but calls may as well be made on demand. It is recommended that guarantees be drafted in conformity and including provisions of the International Chamber of Commerce (ICC) *Uniform Rules for Demand Guarantees* or the *Uniform Rules for Contract Bonds*, as appropriate.

There are two classical categories of Guarantees: accessory guarantees and demand guarantees.

Accessory guarantees. The principal undertakes to fulfill an obligation to another party (beneficiary). The principal asks his bank to issue a guarantee in favor of the beneficiary, which states that in case contractual obligations undertaken by the principal are not observed, are defective, or another form of covered default occurs, the bank issuing the guarantee will fulfill the obligation of the

guaranteed party in favor of the beneficiary. This type of guarantee is known as an "accessory guarantee", and is used mostly in domestic operations and as security in loan agreements.

Demand guarantees. In international practice, in particular in international trade transactions and project finance deals, the established norm is that banks issue in favor of beneficiaries, at the request of the clients of the beneficiaries, what are commonly known as "demand guarantees". In this case, the issuing bank/guarantor undertakes to pay a specified sum of money on the demand of the beneficiary in whose favor the instrument is issued.

Charges

Front-end Commission: This fee, typically charged at the time of signing, covers the administrative costs.

Exposure Fee: This is either: (i) a flat fee; or (ii) a periodic, pro rata temporis, fee, which is usually payable every quarter, and covers the risk borne by the bank. This is often referred to as the Premium.

Commitment Fee: This is a fee covering the capital allocation cost, and is payable for any undisbursed or uncancelled portion of the guarantee for the period between entry into force and expiry dates.

Interest cost: The amount the client owes to the issuing bank for the period between payment of claim under the guarantee and the repayment date.

Types of Guarantees

The most important and frequently used guarantees are the following:

Bid bonds

It is usually required in international tenders, and plays the basic role of avoiding rejection of contracts by tendering companies when awarded to them, due to loss of interest. It also provides protection to the employer or supplier against frivolous and speculative bids and also deter collusive bids being forfeit if the bidder withdraws its bid, or in the case of a successful bidder if he fails to sign the Agreement or furnish the required performance security by a pre- agreed date. In addition, the procedure helps the buyer to avoid multiple tenders of the same contract. The Bid Bond usually covers 1% to 5% of the value of the contract.

Performance bonds

These are required following award of contract and guarantee that the supplier will complete the project correctly. Usually covers 5% to 10% of the value of contract, but may range up to 30% in complex projects.

Advance payment bonds

In cases of contracts extending over long periods of time, the contractor usually requires advance payment. The Advance Payment Bond covers the whole amount of the advance payment (usually 5% to 20% of the project cost).

Letters of indemnity

Are issued by banks against the risk of losing the transport documents, such as the Bill of Lading, to cover the carrier against the risk of delivering the goods to the person not entitled to receive them. Usually covers between 100% and 200% of the value of the goods delivered.

Loan guarantees/project risk guarantees

A bank guarantee provides comfort to the lender that a loan will be repaid. It is most of the times used in lending by a bank located in another country than the borrower and the guarantee is provided by a bank acceptable to the lender situated in the country of the borrower.

Country risk guarantees

A country (sometimes called political) risk guarantee covers the lender against the risk of not being repaid in cases beyond the control of the borrower, but caused by the decision of authorities in the country where the borrower is located. Such risks include, but are not limited to, expropriations, declaration of moratorium on foreign debt, introduction of capital controls, exchange restrictions, etc. In some instances a Country Risk Guarantee may carve-out specified events, with full or partial coverage of guaranteed events.

Stand-by letters of credit (L/C)

A stand-by L/C is a form of demand guarantee issued by the bank of the provider of works, goods or services directly in favor of the beneficiary, and the stand-by L/C is confirmed by the bank of the beneficiary. However, most often the stand-by L/C is issued by the bank of the provider in favor of the beneficiary's bank by way of counter-guarantee that backs a direct demand guarantee issued in favor of the beneficiary by the beneficiary's bank.

Recommendations for Use of Guarantees

Guarantees are an effective instrument to mobilize additional resources to the region and to promote cross-country cooperation, and therefore must be used with proper consideration given to the promotion of these objectives. All project finance, trade finance or operations involving cross-country transfer of funds should qualify. While guarantees up to the single obligor limit may be offered, for the most part the desired size of the guarantee request to BSTDB is in excess of EUR 1 million, but less than EUR 5 million. On the one hand, this would ensure that guarantees would not come to play a dominant role in the Bank's portfolio, but rather would function as a strategic instrument that would achieve ends such as resource mobilization, and increased trade flows and investment in the region. On the other hand, it would also mitigate the effects of possible moral hazard risks, that is the possibility that the negative event(s) covered by the guarantee may become a more likely outcome as a result of the existence of the guarantee.

The Bank may either provide all inclusive coverage for a portion of the financing involved in the operation or transaction, or it may provide partial risk specific guarantees, where it covers specific risk events for up to the entire amount of the financing involved in the operation or transaction. While it is possible to do both of these types of guarantees, from an incentive perspective it is preferable for the Bank to guarantee a portion of the entire amount of financing at risk, even if the events covered are comprehensive. By way of contrast, guarantee of the full amount of financing for a specific set of risks or sub-risks raises moral hazard dangers, as described above.

Practically, guarantees that could be undertaken by BSTDB may include:

Country Risk Guarantees: Since these may cover up to 90% (or even 100% in certain cases) of specific risks, it is particularly important that the conditions triggering the calling of the guarantee should be fully and clearly specified in the contract.

Loan Guarantees: These may be used as a method to mobilize capital to the region at costs below those at which the Bank could itself obtain funding in the international capital and money markets.

Performance Bonds: These guarantees may be used as a way to promote complex projects in the region, which incorporate know-how and technology transfers.

3.2 Exposure and Pricing

Consistent with the Establishing Agreement, guarantees will be subsumed under the limits for single obligor.

Guarantee fee pricing depends on the guarantee's specific coverage and risks. In general, the Bank faces the same processing and supervision costs on guarantees as on other credit instruments. In addition, for headroom purposes guarantees will be treated as if they were on balance sheet, and, from the date when the guarantees can be called, counted in full in calculating the Bank's gearing ratio. Thus, it is the Bank's policy to price guarantee fees in line with the margins it would charge on comparable loans of equivalent risk.

The Bank provides a broad range of guarantees and can consider issuing conditional guarantees or counter-guarantees which fall short of a simple financial guarantee and which allows pricing at lower rates. Such guarantees might be used to apportion risk- sharing in a manner more attractive to other lenders without exposing the Bank to full equity risk.

The Bank's basic guarantee commission and fee structure may consist of front-end fees, exposure and/or periodic guarantee fees and commitment fee components which are meant to provide the Bank with an adequate compensation for the risks assumed and administrative expenses incurred.

Front-end commissions are generally charged and payable at the time of signing of a Guarantee Agreement but not later than coming into force (effectiveness date); the amounts payable will depend on the actual administrative and other expenses incurred by the Bank on the arrangement stage.

Exposure fee is intended to compensate the Bank for the risk type[s] covered by the guarantee (e.g. country, project, currency, etc.). This fee is normally charged as a percentage of the value of the actual exposure of the Bank and may be payable (i) as a flat-charge fee at the time of disbursement or (ii) regularly at the time of interest payments to the lender. The flat-charge fee can vary from 1% to 8 %, while the periodic fee can be set at a range of 0.25%-6% p.a. depending on the scope of the guarantee.

In instances when funding is provided in a currency that has very high levels of annual inflation the rates mentioned above are considered as set in real terms; for the purpose of determining applicable nominal rates they will be adjusted for inflation in the country issuing the currency in which the guarantee is denominated.

The borrower shall be liable for any additional fees and expenses including those associated with the appointment of any independent consultant required by the Bank at any stage of the project development.

The Bank will gradually build up its capacity to provide its clients with a broad range of different forms of guarantees, but in all cases the maximum exposure must be known and measurable.

4. Equity investment

4.1 Description

Under its Establishing Agreement, the Bank is empowered to make equity investments. As equity, all investments are ‘de facto’ denominated in local currency. They may, however, be recorded in hard currency terms using generally accepted international accounting principles. The investments denominated in hard currency may be possible if the local legislation permits it and generally in cases when the target company has foreign currency based businesses. Foreign exchange risks associated with equity investments will be monitored and hedged when possible.

The Bank may make equity investments in a variety of forms. They are primarily direct investments in the form of common or preferred shares. These shares reflect the value of the investee company and thus often involve a currency risk for the Bank. Foreign exchange risk from equity investments is monitored and, when hedging instruments are available at a reasonable cost, is minimized.

Provisioning decisions for equity investment will be based upon a case-by-case assessment of any deterioration in investment value in the case non-traded shares (the typical case). Since the Bank does not intend to be a permanent investor, an exit strategy is part of the initial investment plan and forms an explicit part of the project documentation. This strategy may be updated during the life of the investment.

Exit strategies take into account a variety of considerations. These include the completion of the Bank's role, the investment return, the method of exit as well as the impact on the company and the relevant country.[4]

Decisions on equity exits are approved by the Credit Committee. The Board of Directors is informed of such sales through a timely and systematic reporting procedure. An Equity Exit Information Note is provided to Directors for each exit as soon as possible but within 30 days of signature of the sale and purchase agreement governing the Bank's divestment.

In its equity investments the Bank will never be acting or deemed to act as if holding or hold the control position. Therefore, the Bank manages its equity portfolio as a portfolio of financial assets and not as strategic investments, although in all cases the Bank will seek to be represented in the Board of the investee company. As such, it will normally be a practice that in each of its equity investment operations the Bank will require the participation of, and rely on, the co-investment with the strategic or professional financial investor[s] capable of bringing the country and sector expertise to the transaction and providing the reliable management quality acceptable to the Bank. The Bank will require that the issuing company spend the proceeds of the issue of shares for the objectives as approved by the Bank and specified in the legal documents signed on behalf of the investment.

The Bank’s equity investments may be made in a variety of forms, investing in existing or new ventures and special purpose companies. The Bank may subscribe to both common and preferred equity in the enterprises but in general as a result of private equity placements rather than public offering. The Bank may also make quasi equity investments in various forms, including but not limited to certain types of subordinated loans, debentures, income notes and redeemable preference shares.

The preferred instruments recommended to be used in the Bank’s operations and their main characteristics are:

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[4] These factors are described in more detail in Rules and Regulations for Financing Projects and Commercial Activities (RRFPCA), Section 6, “Equity Investments”.

Common Stock

This is the basic form of equity. It consists of shares of stock, giving the right to the holder to vote in the selection of directors/administrators and other important matters. Although the shareholder has the right to receive dividends, this right is not guaranteed. In case a corporation is liquidated, the claims of the shareholders come last, after secured and unsecured creditors, holders of bonds and preferred stock. Common stock has the most potential for appreciation, and offers most of profit to investors through capital gains (difference between the price of sale and price of acquisition).

Preferred Stock

This is a class of Capital Stock, which does not normally carry voting rights. It pays dividends and offers preference over common stock holders for payment of dividends. It has the advantage of offering a more stable stream of income, above an agreed minimum. It has the disadvantage of excluding holders from much of the decision making process, although they have unrestricted access to information.

There are a number of possible variations of preferred stock structures: (i) cumulative vs. non-cumulative: a past dividend of a non-cumulative preferred stock is usually gone forever, while for a cumulative preferred stock accumulates and must be paid before dividends on common stock; (ii) participating vs. non-participating: participating preferred stock allows holders to share in profits beyond declared dividend, along with common stock holders; (iii) fixed rate vs. adjustable rate preferred stock: the dividend on the preferred stock may be adjustable at payment date (quarterly semiannually or annually) based on changes on a selected money market instrument; (iv) convertible vs. non-convertible preferred stock: convertible preferred stock may be exchangeable for a stated number of common stock shares and therefore has a more volatile behavior compared to non-convertible preferred stock which behaves more like a bond. Combinations of above-mentioned variations are possible.

Mandatory Convertibles

These are debt-equity hybrid products, which are exchangeable at maturity for common stock of a market value equal to the principal amount of the convertible debt instruments. If the holder of the instruments does not wish the common stock, the issuer must sell the common stock on behalf of the holder and pay to her/him the cash equivalent. A variation is represented by “equity commitment notes” whereby the issuer commits to redeem the notes with proceeds from issue of common stock.

Common Stock Equivalent

These are preferred stock, convertible bonds or warrants that binds the issuer to sell and the holder to buy common stock at a specified price or discount from market price at the maturity of the instrument.

Convertible Loan

This is a direct loan with characteristics similar to a “convertible bond”, which gives the right to the lender to purchase common stock issued by the borrower at a specified date or during a specified period, depending on the negotiated clauses of the Agreement, if a number of conditions included in the loan agreement are met.

4.2 Conditions for Investment

Equity investment, like other private sector activities, will first and foremost be assessed according

to its eligibility qualifications and commercial viability. Equity should not be seen as a source of ‘soft’ funds or ‘cheap’ debt. Equity will only be invested when the Bank:

i) invests under terms of manageable risk and equal treatment for participating investors;
ii) perceives clear potential exit strategies;
iii) projects an acceptable internal rate of return to the equity investor.

Consistent with other operations, the Bank will look to invest equity when it provides ‘additionality’ to the transaction. This might result when the Bank:

i) provides support to other investors thus securing their involvement;
ii) promotes FDI between the member countries;
iii) facilitates the fulfillment of privatization policies;
iv) plays a constructive role in the enterprise and provides long-term stability to it during a period of transition and change.

All equity invested by the Bank should be applied to the development of the project or entity. In general the Bank will wish to see its investment contributing to the new capitalization of the company rather then buying out the stakes from the existing shareholders of the company. The Bank’s participation will be significant enough to ensure adequate influence

4.3 Exposure Limits

According to Article 15.2 of its Establishing Agreement, the Bank is not normally looking to take a controlling interest in any company. Typically the Bank would look to take an equity stake of 5-25%. The total portfolio of the Bank’s equity investments would be within the exposure limits set in Part I of this document.

The total committed equity investment to any single obligor may not currently be greater than 3% of paid-in capital.

4.4 Pricing

When considering an equity investment, the Bank will look for a market based rate of return, which will be measured as the internal rate of return on all equity cashflows. As a reference this would be the average rate of return for companies of similar profile in the same sector and facing the similar market conditions.

Although the rates for individual countries will vary, in general, the Bank will be looking for a real return on stand alone equity investment of about 20%. This rate of return may be seen as ambitious but in any particular case it should correspond with the rate of returns received by the other financial investors in the same or comparable projects in the market and it is provided here for guidance purposes.

4.5 Equity contributions

The Bank will always look for cash equity investment in the project from member countries’ investors and in case these are not available, reputable international investors from non-member countries. The Bank will be reluctant to invest in a project where the investors are investing only in kind. Cash equity from member countries companies should be sought but some ‘equity in kind’ will be acceptable. However, the Bank will be particularly cautious to ensure that all investors share proportionally both the benefits and risks of the investment.

4.6 Managing the Investment

The performance of equity investments will be supervised by the Operations Leader responsible

for the operation. If required, he or she will represent the Bank on the board or be responsible for a designated representative. When represented on the board of an investee company, the Bank will not assume executive responsibilities but will seek to provide constructive advice. The Operations Leader will also be responsible to advise on when to exit the investment.

4.7 Exit Strategies

Because it is not the purpose of the Bank to be a long-term investor, a clearly defined exit strategy must be part of the initial investment plan, and must be updated during the life of the investment. The exit strategy for each investment shall be approved by the BoD at the initial stage of the investment and no additional approval shall be needed at the time of exit. Strategies will take account of:

i) *Timing*

The catalytic role performed by the Bank must be seen to have been completed and an independent market value for the investment, whether successful or not, must have been established. This may require a two stage disinvestment, as it may not be considered appropriate for the Bank to withdraw completely from an investment at the time of a public flotation. The Bank will seek to exit within a medium-term horizon.

The Bank will seek to recycle its equity funds after a reasonable period. Subject to possible qualifications, the Bank's general rule will be that it sells its equity holding when the market is favorable enough to enable it to do so with a reasonable return without jeopardizing the investment of the other shareholders.

ii) *Investment gain*

A short to medium term investment will typically have been made through a period of change. The return will generally be taken as an increase in capital value, as income will usually be substantially reinvested through the period. Return will be understood as a total return on the investment, i.e. capital gain and dividends received over the holding period of the investment. The return sought by the Bank in each case will be one appropriate to the risk and the actual change during the period, and though a 20% rate of return is targeted, a range of different results can be expected without necessarily requiring a shortening or lengthening of the period of investment.

iii) *Method of exit*

Exit will generally be achieved by a sale of the shareholding to a private entity at an appropriate valuation, through one of the following channels:

- sale to a trader/buyer;
- an initial public offering / private placement;
- a share placing (in the case of listed securities) within the stock market;
- sale to the management or workforce;
- sale to investment institutions such as pension or mutual funds;
- sale back to the company where allowable.

The Bank will give priority to more transparent and competitive sale methods if the other methods of sale do not clearly achieve a higher price.

5. Special Products

5.1 Underwriting:

In case that the other financing instruments are not appropriate, the Bank may decide to undertake securities by subscribing to specific amounts and values issued by a public or a privately owned enterprise as a way to enhance an issuer's access to international and domestic capital markets to broaden its financial sources.

The Bank's capital market activities include a range of banking activities aimed at promoting the access of borrowing member countries and corporations to the international and domestic capital markets[5].

Underwriting and other capital market services creating client credit exposure to the Bank are subject to the same internal approvals required for loan and equity investments. Underwriting is further discussed in Portfolio Risk Management and Investment Policies.

5.2 Hedging Instruments:

The Bank may also provide its clients with financial management risk instruments either in association with other product or as stand-alone products to hedge their exposure to foreign exchange, interest rate, commodity price or any other project related financial risk. These instruments are used to the extent that the Bank is able to satisfactorily hedge the risks of such products in the financial markets.

5.3 Leasing:

The Bank may provide medium-term financial leverage of leasing transactions. This mechanism will be used as a facilitating vehicle for development of production and trade of capital goods in member countries.

Definition

A *lease* is a rental agreement under which the owner of an asset allows someone else to use it for a specified time (usually minimum one year) in return for a series of fixed payments. Firms lease as an alternative to buying capital equipment. The key actors involved in a leasing operation are: the *lessor* (the owner of the leased asset), the *lessee* (the user of the asset), and the manufacturer or the supplier of the asset. When a lease is terminated, the leased equipment reverts to the lessor, but the lease agreement often gives the user the option to purchase the equipment or take out a new lease.

Types of leasing operations

Leasing companies may be either independent undertakings or specialized subsidiaries of banks or other financial intermediaries. In some cases, leasing companies are setup by manufacturers and suppliers as a tool to stimulate their sales. In developing and transition countries, there are an increasing number of cases when leasing joint ventures are setup by a foreign leasing company and a local investor. Under such an arrangement, the know-how of the foreign leasing company is blended with the local operator's knowledge of the local market.

Depending on the duration and on the possibility to cancel the leasing agreement, there are two

[5] The Bank may underwrite the issuance of debt securities on the part of clients in its countries of operations. The Bank's exposure arising from these transactions will be assessed and the return to the Bank on the underwritten instrument will be determined on the basis of the Bank's loan pricing methodology for an equivalent exposure

main categories:

Operational leases

Those leases which are short-term and cancelable during the contract period, at the option of the lessee. Operational leases are an alternative to *buying* capital equipment. Firms lease instead of buying equipment if the equivalent cost of ownership of an asset (maintenance etc.) is higher than the rate the firm can get from a lessor. Operational leasing is not an appropriate activity for a bank.

Financial leases

Those leases which extend over most of the estimated economic life of the asset and which cannot be cancelled, or can be cancelled only if the lessee pays a penalty to the lessor. Financial leasing is an alternative to *borrowing* funds, as signing a leasing agreement is as if the lessee borrows money. The difference is that under a financial lease agreement – as opposed to purchasing equipment under a bank loan – the lessee gets the right to *use* the equipment, but the *ownership* title goes to the lessor, who finances the deal. Financial leasing may be offered as an instrument directly by a bank, although the established practice is to be carried out through a specialized financial institution.

Financial leases can play an important role in international project finance, for instance for financing erection of industrial plants, or imports of sizable industrial equipment, ships, fleets of rolling stock, trucks, aircrafts etc. Some of the main advantages for the lessees under a financial lease are:

- leasing finance is usually obtained much faster than a bank loan (simpler and standardized application documentation required, faster assessment process, no business plan necessary, standardized – though lengthy – leasing agreement etc.);
- lease payments are tax deductible, while bank-financed equipment must be depreciated over a period of years and only the interest portion is deductible;
- in some instances, the leased equipment may be part of an investment in industrial capacity that attracts additional tax breaks and other investment incentives;
- VAT payment for leased equipment is spread over the life of the lease contract;
- leasing does not overburden the credit side of the lessee's balance sheet, like a traditional loan would;
- leasing avoids having to tie up valuable working capital or credit lines and thus preserves liquidity for other purposes; however, since the lease agreement cannot be cancelled, there may be an obligation to show in the lessee's off-balance sheet accounts the liability for future payments;
- leasing agreements do not usually incur "cross-collaterization", while bank loans usually require pledge on other collateral assets, not just on the equipment to be acquired;
- leasing contracts do not usually impose restrictive covenants on future lessee's borrowing, like a bank loan would; thus, under a lease agreement, the future financial flexibility of the lessee is less affected;
- lease payments can be tailored to fit the lessee's cash flow pattern (e.g. seasonal changes etc.).
- the rules governing leasing denominated in hard currency (both domestic and cross-border) may allow tax deductions for foreign-exchange differences, which is a kind of indexation against inflation, advantageous for the lessee.

The boundary separating operational and financial leasing differs from one country to another.

Variation on the type of lease may also be made depending upon the number of investors

who provide the financing for the leased equipment; there are two such broad types of leases:

Single-investor leases

Under which the lessor finances from its existing resources the purchase of the leased equipment.

Multiple-investor leases

This is particularly used for equipment with high value, when the lessor raises from other investors part of the funds required for purchasing the equipment. A typical case is the *leveraged* lease, the financial lease under which the lessor borrows part of the funds necessary to buy the leased asset, and uses the leasing contract as security for the loan. The lessee's obligation to repayment will be solely against the lessor, whilst the investors' right to repayment will be solely against the lessor.

Another variation can be made depending on the services provided by the lessor:

Full-service (or rental) leases

Under which the lessor ensures the maintenance and insurance and pays the property taxes due on the leased asset. Operational leases usually are full-service leases.

Net leases

Under which the lessee maintains the asset, insures it and pays any property taxes due. Financial leases usually are net leases.

Another variation, depending upon the source of the asset, creates three types of leases:

Direct leases

This is the typical case: the lessee identifies the asset, arranges for the leasing company to buy it from the manufacturer or supplier, signs the leasing contract with the lessor and receives the equipment directly from the manufacturer or supplier.

Vendor leasing

The customer is offered lease finance by the manufacturer/supplier, as part of the vendor's sales package. Therefore, under a vendor leasing, the customer obtains the equipment and the lease finance in a single purchase process. The lessor in this case is either supplier's own leasing subsidiary or a separate leasing company with whom the supplier makes an arrangement, either directly or through a broker, for the provision of the lease finance to creditworthy customers.

Sale and lease-back leases

This is the case in which the owner of an asset sells it to a leasing company and leases the asset back from the new owner. The legal ownership of the asset is transferred to the lessor, whilst the right to use the asset remains with the lessee. Such arrangements are fit for instance in situations when a company acquires a new asset, but realizes that it would nevertheless prefer not to tie up the cash.

Variation of lease types may also be made on the basis of the value of the leased asset, with three broad categories of leasing operations: small ticket, medium ticket and big ticket leases.

Most lessees under small and medium ticket leasing are SMEs. However, thresholds for defining small, medium and big ticket leasing differ from one country to another and depend on the structure of the respective market.

Under a typical lease, the lease payments are even and the first lease payment is due immediately upon signature of the lease contract. However, variations on lease types can also be made on the basis of how payments are tailored to fit the lessee's cash flow pattern. Some categories of tailored-payments leasing are listed below:

Step-up leases

Under which the payments are lower early in the lease term, and higher later on. This type of leasing is attractive for cases when the output obtained by the lessee when exploiting the leased equipment is lower in the initial years.

Step-down leases

Under which the lease payments are higher in the initial years, and decrease along the duration of the lease contract; such leases can be fit for instance when the lessee acquires equipment for special contracts, where usage is higher initially.

Seasonal-payment leases

This is fit for lessees with seasonal business cycles: the lease payments are adjusted to the seasonal cash flow pattern of the lessee, and are higher in the peak business seasons and lower in the quiet seasons.

Skip-payment leases

Under which the lessee is allowed some flexibility to skip one or more lease payments (based on skip-payment vouchers), without compromising its good credit record.

No-payment leases (or deferred rental leases)

These offer a payment moratorium (grace period) at lease inception, for instance to accommodate long business cycles or changeover or transfer to new technology, when new equipment is installed while the old equipment is still in use.

Ballooned-payment leases

Under which, after making a series of regular payments to the lessor, the lessee pays a lump sum (a balloon rental) to the lessor, thus enabling him to fully recover the capital cost of the leased asset.

Another way of distinguishing types of leases looks at the location of the lessor and lessee:

Domestic leases

When the lessor and the lessee are located in the same country. Domestic leases can also be used for financing an export-import deal, in situations when the supplier of equipment is located in another country than the lessee and lessor.

Cross-border leases (export leases)

When the lessor is located in one country and the lessee in another country. The supplier of equipment might be located either in another country than the lessee or in lessee's country.

There are situations when an export credit subsidy and guarantee is available in the supplier's country, while the supply of goods to the lessee is financed by a leasing agreement.

Recommendations and Guidelines for Use of Leasing

1. In line with BSTDB's mandate, leasing operations would have as an overall objective to contribute to the economic prosperity of the BSEC countries, by providing long-term finance for capital investments in the region. In particular, the following goals should be pursued under BSTDB leasing operations:

    - promoting transfer of modern technology and know-how to BSEC economies;
    - supporting private sector development in general- including SMEs;
    - facilitating and enhancing trade in capital goods among BSEC countries.

2. Against this background, the Bank should offer mainly four leasing-related products:

    - Equity in leasing companies;
    - Credit lines/loans to leasing companies;
    - Credit lines/loans to manufacturers, for vendor leasing;
    - Direct net lease agreement.

3. Priority should be given to investment in companies:

    - providing *financial* leasing for capital equipment with high development impact;
    - with a good track record in leasing.

4. Potential clients for BSTDB operations involving equity in, or loans to, leasing companies should be:

    - joint-ventures between (i) leasing companies with successful international experience and (ii) local partners with good knowledge of the local market;
    - local financial intermediaries with a good track record in leasing operations, expanding their business locally and/or to other countries, especially within BSEC;
    - specialized leasing branches established by manufacturers of capital equipment in BSEC countries, as a mean to stimulate sales, either domestically or to other countries, especially within BSEC.

5. Potential clients for BSTDB operations involving credit lines to manufacturing companies, for vendor leasing, would be manufacturers of capital goods expanding their business locally and/or to foreign markets, especially to BSEC countries.

6. As a general rule, minimum BSTDB investment should be US$ 3 million for loans/credit lines and US$ 1 million for equity investments.

7. To the extent possible, BSTDB leasing operations will be based on standardized contract formats, in order to minimize administrative and transaction costs.

8. In exceptional circumstances, when: (i) the value of the asset is relatively high compared to the borrower's financial strength; (ii) the asset represents an investment with a strong

technological content, improves significantly the quality of output, increases productivity, is significantly reducing emissions or otherwise improving the environment, work safety and health conditions; (iii) the legal framework in the country of incorporation of the client is more favorable to lessors than creditors; and (iv) the Bank has good prospects of being refinanced by official financial institutions (US EXIM, JBIC, NIB, KfW, ICO etc.), the Bank may enter with the client into a *direct net lease agreement*. Such an agreement would take the form of *lease receivables discounting*, and may be either a *single investor lease*, or a *multiple investor lease* in case of very high value and complex asset provided that the Bank can secure additional financing through syndication. In this case the fixed asset is paid by the Bank to the supplier but is delivered directly to the client after all legal documents have been prepared, agreed, signed and entered into effect. Such an arrangement has the benefit that: (i) the Bank retains the ownership of the asset, and can repossess it immediately in case an event signifying default has occurred; (ii) the client operates, maintains, insures and pays any taxes due on the asset; (iii) no other security agreement is necessary; and (iv) at the end of the lease period the ownership right on the asset is transferred to the client.

5.4 Forfaiting:

The Bank may provide forfeiting opportunities for its clients normally through its trade finance facilities between the member countries.

Definition

Forfaiting is the process through which a company/seller obtains cash, thus refinancing its exports, by selling without recourse drafts, promissory notes, bills of exchange, deferred letters of credit, or any other negotiable instruments representing amounts due to the seller by its clients. The term “forfaiting” has its origin in the French language, where the term “Forfait” means surrendering rights without recourse.

Forfaiting is a form of medium term financing and can be used for both domestic and international transactions. However, it is mostly used as a form of medium term finance for import transactions of predominantly capital goods. Forfaiting provides to the exporter the same level of comfort as the confirmed documentary credit, with the additional benefit that it may stretch over extended periods of time, while documentary credit is used usually for short-term transactions of up to 360 days.

Although forfaiting still represents only a modest share of total trade financing, its use is growing rapidly, including in Eastern and South-Eastern Europe. In recent years, forfaiting has assumed an important role for exporters who desire cash instead of deferred payments. Also there is a rapidly developing market in secondary trading, principally located in London. Accordingly, major banks are beginning to treat forfaited documents more as investment products rather than trade finance instruments.

Charges

Option fee: For option periods between 24 hours and up to 6 months the forfaiter charges a “waiting fee”. This fee is used rather rarely and is charged for a commitment made by the forfaiter to discount the documents before the contract between the exporter and the importer is finalized. The period over which the fee is charged covers the difference between the moment the commitment is made and the moment the export contract is signed.

Commitment fee: For the entire commitment period, applicable to the amount not yet discounted upon presentation of previously agreed documents.

Termination fee: Charged by the forfaiter in case it agrees with the seller/exporter's demand to terminate a forfaiting agreement. The seller can make this request at any time during the commitment period and the forfaiter may agree or disagree with the request. The forfaiter may not terminate the forfait contract from its own initiative.

Discount rate: This includes interest margin calculated on the underlying cost of funds, interest rate risk, country risk, and possibly currency risk (if there is a difference between the currency advanced to the seller/exporter and that of payment by the buyer/importer, although such a procedure is unusual). Normally the interest equivalent of a discount rate is higher than the corresponding interest rate charged on similar transactions financed through outright debt.

Guidelines and Recommendations for Use of Forfaiting

Forfaiting is a proven method of providing fixed rate medium term export finance for international trade transactions in capital goods. It is most appropriate for export of capital goods, with payment stretching over periods between 1 and 5 years, and the optimum operation size of EUR 5 million. The mentioned transaction size refers to an individual document; the value of the entire forfaiting operation may go up to the single obligor limit and may include several documents.

Generally, export receivables are guaranteed by the importer's bank. This allows the forfaiter to discount "without recourse" to the exporter, thus taking the transaction off the exporter's balance sheet. This can have important benefits for the exporting company's key financial ratios.

Typically the importer's obligations are evidenced by accepted bills of exchange or promissory notes which a bank avals, or guarantees. The notes are then said to be avalized. Equally the receivable may take the form of a term draft drawn under documentary letters of credit.

Forfaiting is often applied where the exporter is selling capital goods, and having to offer export finance up to five or six years. The forfaiter will then quote a price being a discount rate to be applied to the paper. It is usually possible to have a fixed price quoted, and the exporter is thus able to lock into his profit from the outset.

There is an active secondary market for avalized export finance paper in London, and this market can be accessed on behalf of clients, to seek financing solutions. BSTDB will only enter into transactions with the beneficiary of the payment in whose favor the document was issued. The secondary market will only be used in cases when the Bank believes it is cost effective to sell documents it has forfaited, and not for purchase.

Due to its characteristics as trade finance instrument and investment product, forfaiting is an instrument that BSTDB should employ, when warranted. It is the appropriate instrument to use for promotion of intra-regional trade in capital goods, and thus help achieve the Bank's mandate. BSTDB may act either as the forfaiter of the exporter or as the avalizer/guarantor of the importer, as appropriate.

5.5 Discounting:

Definition

Discounting is a procedure through which a company is offered the same real cash flow benefits that factoring offers, but without the client's obligation of losing control of the sales ledger. It is usually a confidential service. In contrast to factoring, discounting does not require establishment of a separate specialized team to carry it out. As the discounter does not purchase the ledger from the client, the discounter is under no obligation to follow up, and collect, the accounts receivable. Discounting is a facility/service offered by banks and factoring companies to well-established profitable businesses with an effective and professional sales ledger administration system (accounts

receivable administration and collection).

Charges

Service charges (often known as "commission charges") are usually lower than for factoring due to the fact that the sales ledger administration is still the responsibility of the client. Often a discounter will try to match or beat the rate currently being charged by the client's bankers.

There are two main charges in invoice discounting agreements:

Service Fee: This is a percentage charge on the discounted documents value, usually of 0.125% to 1.50%.

Cost of Money: This is an interest charge on the funds advanced by the discounter over bank base rate.

Guidelines for Use of Discounting

The items below are not exhaustive and it is always the discounter that will make the final decision on what is suitable for it or not:

1. Mainly Limited Companies, but is possible for Sole Traders and Partnerships;
2. Turnover range EUR500,000 up to EUR200 million;
3. Can be Confidential or Disclosed;
4. Profitable Trading history preferred (usual minimum net worth requirement is EUR50,000);
5. Ideally 5 to 6 live customers on the sales ledger preferred;
6. Funding levels usually from 50% to 100% of discounted document value;
7. Trade credit sales only can be discounted, not debts to the public;
8. The business must be able to demonstrate good cash management and accounts receivable collection management systems;
9. Both domestic and export receivables can be funded.

Concluding Remarks and Recommendations

Discounting is the fastest growing sector of the sales linked finance market, and as such, the ability to package deals with this product is becoming increasingly required, and the instrument is in rising demand in BSTDB Member Countries. It is of greatest interest to businesses which have to import or purchase domestically large quantities of finished goods, for which they have confirmed orders from creditworthy customers.

Discounting is becoming increasingly used alongside stock finance, term loans and trade finance to offer a full asset based lending package, often with very attractive cost structures for the prospective clients. However, this instrument it less suitable for BSTDB, as the regional cooperation or development impact of such operations is usually difficult to identify.

The instrument is therefore more appropriate in trade finance operations, as a form of short-term credit. In particular it can be very helpful as part of a funding package for a business dealing with financially stronger customers. As the process is a transactional one, based very much on the strength of the end user, this facility is particularly useful for businesses whose own balance sheet is not strong enough to support the level of funding required. BSTDB could use this instrument selectively. It is recommendable for the Bank to use it in conjunction with other trade finance products, discounting representing a relatively small portion of the financing package.

6. Programs

6.1 Trade Finance

Introduction

Trade Finance is a distinct core business of the Bank and deserves separate treatment due to its relative importance in the Bank operations as specifically mentioned in the Purpose, Functions and Powers Articles of the Agreement Establishing the BSTDB with the aim to finance and promote intra-regional trade among the Member Countries and facilitate increased volume of exports from Member Countries within and outside the region as further stipulated in BoG approved Rules and Regulations for Financing Projects and Commercial Activities.

Therefore, BSTDB Trade Finance Program provides a broad range of most comprehensive products to finance and promote trade of goods within and outside the region with the objectives;

i) to promote further development of the regional economic cooperation and increase the volume of trade between the Member Countries;
ii) to assist Member Countries to diversify exports, expand into new markets and to help improve competitiveness of regional products, especially for capital goods;
iii) to promote production and exportation of goods with increased value added content, to generate foreign exchange and promote job creation; and
iv) to modernize the capital equipment through import of technologically advanced and environmentally friendly equipment.

With this in mind, the BSTDB's export financing facilities provided to suppliers/exporters may support exports from all Member Countries destined for countries inside as well as outside the Member Countries, while import financing facilities support imports.

Description

BSTDB Trade Finance Program use a number of instruments described in this document (e.g. direct loan, lines of credit, guarantees, discounting, forfeiting, and leasing) designed to address funding needs of suppliers/exporters and /or buyers/importers of Member Countries.

Trade Finance business will predominantly be conducted through selected financial intermediaries (such as commercial banks, leasing companies, ECAs and development banks) within the framework of a credit facility agreement signed between the Bank and financial intermediary for the following reasons:

1. Most Trade Finance operations will normally require a financial intermediary to performdue diligence on the beneficiary (local supplier/exporter or buyer/importer) and assume that beneficiary risk -- the BSTDB has limited resources to reach beneficiaries in Member Countries, perform due diligence on them and assume the related risks.

2. Most individual Trade Finance transactions are small in size and direct BSTDB involvement would be prohibitively expensive for the Bank.

3. Funding will be available for utilization of beneficiaries at all time during the effectiveness of the facility, while direct financing could be provided only after signing a loan agreement following completion of BSTDB Operations Cycle.

4. In the interest of facilitating economic development in member countries, the BSTDB will support local financial intermediaries and help them grow, rather than remove local financial institutions from a transaction by operating directly with the beneficiary.

5. The BSTDB intention is to work with local financial institutions and support their development and capabilities to provide better service and a broader range of financial products.

6. The Bank will sign a loan agreement for each facility and will be able to set financial, affirmative and negative covenants on each loan agreement in order to better mitigate its risk, rather than relying on a guarantee or payment obligation (such as L/C, promissory note and draft) of such financial intermediary.

Selection and monitoring of the financial intermediaries will be made in accordance with the Guidelines for Appraisal and Selection of Financial Intermediaries, the Operations Cycle Policy and the Operations Manual.

Methods of payments, which are eligible under trade finance operations, will vary depending on the type of facility.

Co-financing may also be undertaken with other reputable, qualified financial institutions.

The Bank will typically consider Trade Finance operations through financial intermediaries when the amount of individual operations is too low to be cost-effective for the Bank. The Bank will also consider direct applications for larger amounts to finance exports or imports of interested beneficiaries.

Trade Finance facilities can be either short -term with a tenor of up to 360 days or medium/long-term with a tenor of up to 5 years. In exceptional circumstances long- term tenors may be extended for up to 10 years.

Trade Finance operations shall comply with the relevant Bank policies, strategies, guidelines, methodologies, rules and regulations.

Transactions involving goods mentioned in the BSTDB's Exclusion List will be excluded from financing.

The Bank's Procurement Principles and Rules are applicable to trade finance activities, but most such activities will fall under section five which states that where Bank funds are used through financial intermediaries and the tenor of financing is less than four years the principles and rules are relaxed to the extent that procurement shall be carried out according to sound commercial practices and on an arm's length basis.

Exposure

While Trade Finance instruments can cover up to 100% of a transaction, the BSTDB will encourage risk sharing and co-financing when appropriate.

Depending on the risk involved, the Bank may provide unsecured and secured trade finance facilities and may ask for different kinds of collateral, as stipulated in the "Security Under Banking Operations" document and as the transaction may require under sound banking principles.

Depending on the borrower the Bank may provide uncommitted and committed facilities and have exposure to either financial intermediary or exporter/importer. In order to effectively utilize the credit facilities the Bank will mostly provide committed loan facilities to financial intermediaries, while providing uncommitted financing for guarantee facilities to selected financial intermediaries in the Member Countries. In the case of guarantee facilities the Bank's exposure will be calculated on the aggregate amount of guarantees issued and outstanding under the facility.

Pricing

The Bank can offer fixed or floating interest rates for trade finance facilities, consisting of a base rate and a margin charged on the outstanding amount of the loan. In addition to above, fees and commissions that will vary depending on the products, will be charged.

On the other hand, guarantee fees will be charged as a percentage of the guarantee amount per annum and will vary depending on the risk involved.

The pricing of Trade Finance loans and guarantees shall be determined in accordance with relevant documents approved by BoD.

6.1.1 Export Finance Facilities

Introduction

The purpose of the export finance facilities is to provide financial support to suppliers/exporters in the Member Countries to enable them to perform export transactions. Under this category, the Bank offers Pre-export Finance,

Single/Multiple Supplier Refinancing Facilities and also Export Finance Facility Guarantees.

BSTDB will pay due consideration to promoting exports of goods with significant local content; such preference, in particular in operations financed through financial intermediaries, shall be stated by the Bank to its client/intermediary who has the subsequent responsibility to comply with the appropriate specific provisions of local legal requirements regarding minimum local content, if any.

The loans may cover both pre-shipment and / or the post-shipment periods of an export transaction.

Typically, suppliers/exporters loans will be short-term. Longer tenors may apply to cases where traded goods have long manufacturing periods (e.g. capital goods) and /or trade contracts terms provide deferred payment options.

6.1.1.1 Pre-export Finance Facility

Purpose

Pre-export Finance Facility is designed to provide financing to suppliers/exporters in advance necessary to produce manufactured goods, commodities and agricultural products for export and also extend deferred payment terms to their buyers, if needed.

The rationale is that while companies in the Member Countries may be able to secure export contracts, they often do not have the financial support necessary to produce for export or accept deferred payment terms. Once the exporting company has signed a contract, it must have the means to purchase the materials and other resources necessary to perform under the contract. The BSTDB Pre-export Finance loans address the needs of suppliers/exporters for necessary funding.

Description

- Pre-export Finance Facility is typically available through selected financial

intermediaries, normally banks and export credit agencies (ECAs), located in the Member Countries, to which the BSTDB has extended a Pre-export facility.

- The intermediary in its turn on-lends to exporting companies located in the Member Countries. The Bank assumes the risk on the intermediary for which a Pre-export facility has been established, while the intermediary assumes all the related risks of the beneficiary.

- BSTDB Pre-export Facility will be committed and could be extended on revolving basis.

- Where there is no Pre-export Finance Facility of BSTDB available or the facility amount is not sufficient, BSTDB will examine requests from end beneficiaries directly for financing a large- scale one-off export transaction when such request meets the conditions outlined in this document.

- Suppliers/exporters may utilize the funds under the facility within a period not exceeding the maximum tenor of the facility. Shipment should take place within the tenor of relevant disbursement. Repayment of each disbursement will be made at the end of the tenor of relevant disbursement by the financial intermediary irrespective of whether the funds have been repaid by the beneficiary or not.

- The BSTDB Pre-export Finance Facility provides financing to transactions when the goods being exported are produced in the Member Countries and comply with the minimum local content provisions set above.

- The Bank will accept all methods of payment under the Pre- export Finance Facility transactions financed through Financial Intermediaries. The Bank reserves the right to monitor transactions and may require information from the intermediary in this regard.

6.1.1.2 Single/Multiple Supplier Refinancing Facility

Purpose

The purpose of this Facility is to help suppliers/exporters in the Member Countries sell capital goods in large amounts to markets in other Member Countries and elsewhere with medium and possibly long-term credits. These transactions can include goods such as heavy equipment, machinery, vehicles, and other capital goods.

The BSTDB's Single/Multiple Supplier Refinance Facility is a mechanism for export promotion. The supplier/exporter is provided financing by BSTDB against deferred payment receivables, either directly from BSTDB (Single Supplier Refinancing Facility) or via a qualified financial intermediary (the Multiple Supplier Refinancing Facility). The Facility enables companies in the Member Countries to enter markets with medium and long-term supplier credits that would otherwise be closed without such financing.

This Facility also enables exporters in Member Countries to compete with other exporting countries in international bids/tenders where credit plays an important role in securing the contract.

Description

- In most cases, Supplier Refinancing Facility would be offered to exporters (operating in Member Countries) through selected financial intermediaries under the Multiple Supplier Refinancing Facility. As such, the BSTDB will take the intermediary risk. The Intermediary will take the buyer risk, but it is most likely that the buyer's payment obligation will be insured (likely by an ECA) or guaranteed by the buyer's government or an acceptable bank.

- While BSTDB's Facility is not covering risk for the financial intermediary it provides financial intermediary with the liquidity necessary to provide financing against deferred payment instruments issued by buyer (e.g. Promissory Notes).

- In the event a financial intermediary is not comfortable assuming the related risks, the buyer could apply for support under BSTDB's Buyer Credit Facilities in order to get the financing required.

- The financial intermediary will, with BSTDB Supplier Refinancing Facility, provide financing to the exporter against deferred payment receivables.

- Depending on the goods involved, the buyer may be required to provide a down payment (normally 15% of the FOB value, which is often financed by a commercial bank). The BSTDB's Supplier Credit Facility will finance up to 85% of the FOB value when an advance payment is required. In the event no advance payment is required, the BSTDB can finance up to 100% of the transaction.

- Supplier credit involves financing for medium (and in exceptional cases) long terms.

- The BSTDB will determine the appropriate tenor of the credit based on the following factors:

  i) Nature of goods to be exported and anticipated life-span
  ii) Extent of foreign competition
  iii) Contract value
  iv) Importer's country risk
  v) Condition of the market

- The Single Supplier Refinancing Facility is limited to transactions involving amounts of at least USD 5 million. Minimum amounts eligible for support under the Multiple Supplier Refinancing Facility shall be determined subject to discussions with each intermediary.

6.1.1.3 Export Finance Facility Guarantee

BSTDB will accept requests for providing Guarantees with the aim to guarantee the payment obligation of a selected financial intermediary in a Member Country for export finance loans extended by international banks, – typically an IFI or national financial institution/agency.

Such guarantees will be issued to cover the country risk and commercial risk of a financial intermediary to enable them to obtain external financing in

competitive terms, which otherwise would not be available without BSTDB's guarantee.

6.1.2 Import Financing Introduction

BSTDB provides import financing typically through financial intermediaries to buyers/importers in a Member Country to finance multiple contracts for imports of commodities, capital goods and manufactured products.

These Loans are provided to increase competitiveness of goods produced in Member Countries and may improve the competitive position of manufacturing exporters in the region. To compete effectively, Member Country exporters are quite often called to offer buyers financing at par with the financing offered by competitors outside the BSTDB region.

In case medium/long-term tenors are required, these will be determined on a case-by-case basis using non-exclusively the following criteria:

i) Nature of goods to be imported and anticipated life-span
ii) Extent of foreign competition
iii) Contract value
iv) Country risk
v) Condition of the market

6.1.2.1 Multiple Buyer Credit Facility

Purpose

The facility provides financial support to buyers/importers in a Member Country to enable them to import goods.

This Facility aims to:

i) promote further development of regional economic cooperation and trade
ii) increase the competitiveness of regional products
iii) promote the trade of capital goods, which have a strong development impact, such as machinery, manufacturing equipment, durable consumer goods and raw materials.

Description

The Multiple Buyer Credit Facility (MBCF) will be offered through loans extended to financial intermediaries (commercial banks, leasing companies or export credit agencies) for the purposes of providing buyer credits to numerous importers in a given Member Country. For all the facilities the bank will sign an agreement. BSTDB will assume risk of the financial intermediary technically accepting the country risk and commercial risk related to the respective intermediary while the beneficiary (importer) risk will be taken by the financial intermediary.

Both pre-shipment and post-shipment periods are covered under this facility for short and medium term transactions. Multi-Buyer Credit Facilities will be committed and could be extended on revolving basis. It is written at the beginning The Bank will reserve the right to request and obtain any information in order to properly and effectively monitor a transaction.

The Bank will offer two types of Multiple Buyer Credit Facilities, depending on the

requirements and established business practice of the selected financial intermediary:

1. First type of MBCF will require the financial intermediary to issue documentary credits for the relevant underlying import transaction and to nominate BSTDB as the reimbursement bank in the letter of credit. When the letter of credit is issued, the financial intermediary will request BSTDB to pre-approve it in order to commit support for the transaction. If it is required BSTDB may issue its reimbursement undertaking to claiming bank, which is a type of guarantee to secure the payment obligation of issuing bank under the L/C. Once the import transaction has taken place, the exporter will present the relevant documents to its advising bank in the country of export, which will present them to the financial intermediary that had issued the letter of credit. Upon receipt of claim from the advising bank, the BSTDB will disburse the funds equal to the value of goods shipped directly to the advising bank and inform the financial intermediary. The financial intermediary will repay the BSTDB's loan as per the repayment schedule of the facility.

2. Second type of MBCF may accept all methods of payment for the underlying import transaction. The financial intermediary will present requests for disbursements to the Bank in accordance with the terms of the MBCF agreement. The Bank will make the disbursements in advance for realization of import transaction and verify the use of funds for each disbursement on the basis of supporting documents to be provided by the financial intermediary to ensure the compliance of the transactions to criteria established in the MBCF agreement. The financial intermediary will repay each disbursement at its maturity date.

6.1.2.2 Single Buyer Credit Facility

Purpose

To provide medium and (in exceptional cases) long-term financial support to Member Country beneficiaries (buyers/importers) requiring large-value supply contracts and purchases of industrial machinery and other capital goods.

Requirements for these kinds of large purchases are substantial in the region since many local banks have limited resources/liquidity to offer medium and long term financing, and exporting companies are not able to get the supplier/exporter credit support they require from banks.

Description

In considering financing any single, one-off, large-scale import, it is unlikely that the BSTDB would assume direct buyer risk, and adequate security may be required. Such security may include:

i) Letter of Credit or cash for advance (down) payment
ii) An additional Letter of Credit or Guarantee from an acceptable bank in the importer's country or in a third country
iii) A sovereign Guarantee

The BSTDB may also provide a Single Buyer Credit Facility to a financial intermediary, through which a sub-loan would be provided to the buyer – in this

case the financial intermediary would assume the buyer risk and the BSTDB would assume the country risk and the commercial risk of the financial intermediary.

The minimum amount required for a Single Buyer Credit Facility is EUR 4 million. In the event a buyer wishes BSTDB Buyer Credit support for an amount of less than EUR 4 million, an application should be submitted under the Multiple Buyer Credit Facility.

In the event an advance payment is required, and no other financing is available, BSTDB will be in position to cover up to 100% of the transaction value under the facility.

Appropriate tenors are determined by the following factors:

i) Nature of the goods to be imported and anticipated life-span
ii) Extent of foreign competition
iii) Contract value
iv) Importer's country risk
v) Condition of the market

6.1.2.3 Import Finance Guarantee

Purpose

Import Finance Guarantees are substitute for provision of credit intended to help increase trade volumes among Member Countries by providing country risk and commercial risk cover on acceptable short- term trade finance instruments of issuing banks in Member Countries.

BSTDB Import Finance Guarantees may benefit eligible Member Countries beneficiaries by providing:

- cover for commercial and country risks
- improved competitiveness
- improved cash flow position
- access to deferred payment terms.

Description

BSTDB Import Finance Guarantees only apply to trade finance instruments issued by selected eligible banks within the Member Countries.

BSTDB may guarantee the following trade finance instruments:

- avaled drafts or promissory notes;
- stand-by letters of credit;
- letters of credit.

The Bank assumes payment risk (country risk and/ or commercial risk) of the bank issuing the trade finance instrument, either in full or up to an agreed percentage. BSTDB will normally encourage risk-sharing with confirming banks and trim its pricing according to the amount of risk being assumed by the confirming bank.

6.1.3 Combined Trade Finance Facility

BSTDB offers to eligible financial intermediaries the possibility to apply and obtain combined Trade Finance Facilities (CTFF) enabling them to provide credits to both suppliers/exporters and buyers/importers under a single loan agreement. In the case of CTFF the Bank will provide loans to financial intermediaries to on-lend for both pre-shipment/post-shipment financing to exporters as well as pre-shipment and post-shipment financing for importers, accepting all methods of payment for the underlying transactions. In the TFF structure, the Bank will combine the Pre-export Facility and Multiple Buyer Credit Facility under a single limit extended to the selected financial intermediary and the relevant CTFF agreement will establish all terms and conditions of the facility. Terms and conditions and use of funds under TFF will replicate Pre-export Facility and Multiple Buyer Credit Facility characteristics.

6.2 SMEs

6.2.1 Qualifying criteria for a SME

Eligible SMEs must be any entity engaged in an economic activity, irrespective of its legal form, dully registered as legal businesses, which must demonstrate:

- significant growth potential, with relatively modest capital requirement
- that they can generate sufficient cash-flow to cover loan repayment;
- appropriately experienced sponsors/management with a strong track record and good operations and financial management skills to profitably run the business;
- a sound financial basis and well-structured financing plans
- well-prepared and specific business plans
- a clear programme for project implementation with a relatively short time span
- strong competitive prospects in relevant local/regional markets
- prospective investment returns (internal rate of return/ profitability ratio) over the investment/loan repayment period of at least 30 per cent
- no need for significant technical assistance
- no court litigation underway on environmental liabilities, unclear property
- that they do not have overdue obligations to budgets and/or banks rights (lack of title for instance), or similar

In addition to the above, eligible SME sub-borrowers must

- Have no more than 250 employees, excluding seasonal workers;
- Have annual turnover of not greater than €50.000.000 or assets of not greater than €43.000.000
- Not have any direct or indirect shareholder, either domestic or foreign based, that holds legally or beneficially more than 25% of its share capital and that has more than 250 employees, excluding seasonal workers;
- Not have any Affiliate that has more than 250 employees;
- Not be majority owned or controlled by the national or local government or government agencies;
- Not be adjudged bankrupt or insolvent, or ordered to wind up or liquidate its affairs, by a decree or order entered against it by a court;

6.2.2 SME sector support program

In order for BSTDB to have a clear SME sector support program and a consistent set of guidelines to favor implementation, it needs to establish:

- Objectives;

- Monitoring indicators; and
- Instruments

Objectives

Among the most important objectives of the Bank's intervention in support of SMEs are:

- Providing financial support at affordable terms to fast growing small and medium size-companies in manufacturing, food processing, transportation, construction, telecommunication and hi-tech sectors, market and social services.
- Increase export capacity.
- Promote job creation and revenue generation.
- Increase competitiveness of firms in the member countries.
- Promote intra-regional investment.
- Facilitate know-how and technology transfer.
- Mobilize external capital to the region.
- Facilitate networking.
- Improve financial sector ability to deal with and supply financing to SMEs.

The above mentioned objectives could be achieved by adequately addressing the following technical and institutional arrangements:

- Development of retail lending capacities in the participating financial institutions;
- Institutional arrangements to deliver technical assistance, where necessary;
- Support for the development of micro-finance and specialized small enterprise finance institutions; and
- Leasing as a financial technique.

Monitoring Indicators

For SMEs interventions to be effective, the evaluation of results has to go beyond traditional measures that have focused on number of loans, average size of loan and repayment rate. Acknowledging the importance of the above mentioned indicators, measurement of the successfulness of direct interventions must include:

- Cost-effectiveness of operation;
- Transaction costs;
- Coverage;
- Sustainability;
- Magnitude of intended effects;
- Developmental impact (Jobs, Know-how and technology transfer, up and downstream linkages, networking, export growth).

Instruments

Credit Guarantee Funds

These are profit maximizing private sector ventures benefiting of financial support and technical assistance from donor institutions and governmental agencies. They provide maximum benefit when express genuine public private sector partnership, which is governments demonstrated commitment to the development of strong SME sector.

Credit Guarantee Funds may be an example of an effective public-private sector partnership, where under private management, but under favorable public sector sponsored legislation, a blend of private and public funds could be put to work to determine banks to expand their lending to the SME sector.

Experiences of successful credit guarantee institutions in Central and Eastern Europe show that there are six requirements for a good program:

(i) clearly defined mission and strategy;
(ii) appropriate selection of the target group;
(iii) effective use of resources;
(iv) provision of technical assistance to borrowers;
(v) strong commitment to local businesses and person-to-person relationship with the borrowers; and
(vi) strong leadership in implementing credits.

Microfinance/SMEs Specialized Financial Institutions *(e.g. development banks, promotional banks, non-deposit taking finance institutions, non-bank credit institutions, savings banks, rural development banks)*

The appropriate institutional and legal infrastructure for microcredit institutions has not been adequately developed in BSTDB member countries. Microcredit organizations in BSTDB member countries need a combination of capacity-building, funding, policy development and performance-based objectives to develop into professionally managed, permanent and self-sustainable institutions. Specialized SME banks and specialized SME departments in commercial, savings and development banks are key requirements for effective and sustainable SMEs access to finance.

Providing credit, training and counseling could have a positive impact on the private sector and its corresponding financing institutions development. The Bank could benefit from the cooperation and co- financing of microcredit institutions with other IFIs active in the Region and/or bilateral official donor agencies. Microcredit programs should be considered alternatives to poverty alleviating programs, because they promote self-employment and economic self-reliance of poor and low- income families.

Venture capital/Equity Investment Funds

By participating in Venture Capital/Equity Investment Funds, BSTDB would benefit of certain economies of scale especially in the form of: lower costs; more regional approach; increased synergies among the recipient companies, which in turn would result in increased regional co-operation.

While an equity investment is inherently riskier than straight debt financing, it potentially provides higher returns in the medium to long term. On the other hand, being in a position to obtain in depth knowledge about investee companies' operations and financials could potentially provide opportunities to limit risk beyond what is realistically possible in our countries of operation for debt instruments. In our countries of operation registration of security, foreclosure procedures and market realization of security/collateral require long and cumbersome procedures with unpredictable outcome. A lender is a passive observer of outcomes after all information becomes publicly available; on the contrary, a shareholder is an active participant in the decision making process having the ability to influence it positively. Also exit from an equity investment – at least theoretically – is easier than from a corresponding long term loan. However, exit possibilities and the right to exercise any of the pre-agreed options should be clearly established.

Venture capital firms are profitable investment vehicles in environments where the

private sector is developing rapidly, the economy is export oriented, markets are liberalized, and the capital market is well structured and regulated adequately.

Return from equity investment is higher than from a loan, but the cash- flow income does not come with the periodicity of interest; most of the times the bulk of profit is realized at exit due to the fact that capital gains are more important than dividend flows. Despite this "negative" characteristic of equity investment when compared to lending, the implicit developmental impact, positive externalities, job creation, promotion of member countries capital and more broadly speaking SME promotion are positive elements in favor of promoting equity financing.

A mid-sized company in our region would prefer obtaining equity financing, as opposed to debt financing, for the following reasons:

- To attract a reliable, experienced or reputable entity as an equity partner in the venture; in this respect, the presence among shareholders of an IFI or a multinational fund would be perceived by other interested investors as a "certificate" and would therefore help the company raise additional funding in form of both equity and/or debt.
- To increase the capital base of the business, so that banks can be in a position to provide further debt financing (increasing the leverage base; "healthy balance sheet"). Companies in our region are generally speaking overleveraged; that is, the amount of debt is excessively high when compared to the given level of equity capital contributed by shareholders and therefore the ability to obtain any new debt is severely constrained.

Leasing

When repayment of loans looks problematic and equity investment risky, leasing (usage rights to the lessee and property rights to the lessor) could be appropriate.

Financial Leasing is a contractual arrangement between a party (the lessee) allowed to use an asset and the leasing company owner of the asset (the lessor) in exchange for pre-established periodic payments.

These payments cover the cost of purchasing the asset by the lessor, interest cost and a profit margin. A leasing contract may or may not include a purchase option at the end of the contract.

Financial Leasing is an effective financing instrument in cases of companies with limited capital base and insufficient credit history, because the lessor preserves ownership of the assets and relies on the SMEs ability to pay upon agreed installments purely on the basis of cash-flow. It is a useful instrument to replace medium to long term loans for purchases of equipment and technology, as it overcomes problems related to collateral requirement.

Leasing is an effective instrument to provide medium to long term financing to SMEs in places where there is in place a conducive regulatory environment. The most important features of a proper legal and institutional environment for the promotion of financial leasing are: (i) clear definition of rights and duties between the lessee and the lessor; (ii) automatic right of repossession of leased assets by lessors in case of lessee's default; (iii) lessee's right to use the leased asset without restrictions; (iv) few and clear regulatory requirements for leasing companies (such as minimum capital and debt/equity ratios); (v) possibility for the lessor to depreciate the asset over the life of the lease; and (vi) possibility for the lessees to deduct lease payments

from taxable income (lease payments treated like expenditures).

Credit Lines through Selected Financial Intermediaries

Credit lines have the purpose to provide selected banks with medium-term capital not available in the market and to encourage establishment of long term relationship between banks and SMEs.

Financing is to be provided in the form of loans (credit lines) through client commercial banks incorporated in the respective member country with a large branch network and prior good quality experience in SME financing. The borrower will be the each participating financial intermediary. The loan has a 3 to 7 years maturity.

Sub-loans are to be provided on commercial basis terms and their maturity cannot exceed the remaining time to maturity of the credit line.

Funding for SMEs may be used for any of the following purposes:

- Financing of specific projects or investment programs for the creation, modernization, expansion and diversification of industrial, production, agricultural or service-related facilities, provided that the proceeds of the Loan shall not be used to finance more than 50% of the overall cost of any specific project or investment program;
- Working capital financing for industrial, agricultural or manufacturing enterprises for production or service-related purposes and medium- term incremental or start-up working capital requirements for specific projects or investment programs; and
- Export and pre-export financing of industrial or agricultural enterprises manufacturing for export and producing hard currency revenues.

Participating banks will have to agree to adopt SME lending as a significant part of their business and the loan agreements with BSTDB will encompass specific performance criteria by which BSTDB can verify that sub-loans are being used for the agreed purposes.

Sub-loans are usually available with maturities of a maximum of three years and grace period of up to 6 months. Where investment is required for modernization or expansion of capacities, the investment time span is three to five years, one-year grace period and an availability period of up to one year.

Credit applications are submitted by prospective borrowers to participating financial intermediaries' offices or agreed "credit brokers". A specialized group of staff, normally located in the financial intermediary's headquarters, shall be responsible for the appraisal and supervision of the sub-loans from the credit line.

7. Co-financing

7.1 Description

One of the key tasks of the Bank will be to mobilize foreign and local capital, both public and private, for loans and guarantees in its countries of operation. Co-financing is one of the most effective ways to mobilize such funds, since co-financiers can take full advantage of the Bank's advisory capacity, its financing and project evaluation activities as well as its in-depth knowledge of the economic strategies of its countries of operation.

Co-financing, especially from development institutions sources, often results in borrowers obtaining financing to which they would not normally have access and in negotiating more favorable terms (e.g. lower interest rates or fees or longer maturates) from other lenders. In short, through co-financing, the Bank will be able to increase the volume and quality of loans to its borrowers and to diversify their financing sources.

7.2 Definitions

The Bank may interact with a variety of other lenders including multilateral development banks, bilateral development finance institutions, export-credit agencies, official lenders or guarantors, commercial banks, and other financial intermediaries. Examples of the different forms of interaction with other lenders include:

i) *Joint Co-financing*

The Bank's and the co-financiers' loans are used to finance, in some agreed proportions, the same set, or package, of goods and services required for a project. This implies that the procurement of these goods and services is done by the borrower in accordance with the Bank's procurement rules.

The loans will usually be made under separate loan agreements, with appropriate cross references and optional cross default clauses.

ii) *Parallel Co-financing*

The Bank's and the co-financiers' loans are used to finance separate packages of goods and services. In this case, the packages financed with the Bank's loan will have to be procured under a procedure satisfactory to the Bank's rules, while the procurement of the other packages financed by the co-financiers' loan may be done under procedures agreed between the borrower and the co-financiers as long as those procedures ensure economy and efficiency.

The loans will be made under separate loan agreements, often with appropriate cross references and optional cross default clauses.

iii) *Participations*

This technique can be employed to bring in other lenders and transfer a portion of risk from the Bank to these lenders, thereby allowing them to partially finance the initial loan or increase their commitment. The participations lead by the Bank may involve variety of structures. The Bank may agree to make a loan to finance an operation but provides its commitment only to a portion of the loan with the other commercial banks subscribing for the balance. The Bank may also, sell its participation in the loan after commitment or even after disbursement to one or several commercial banks without recourse.

iv) *Syndications and Consortium financing*

In these co-financing techniques the Bank joins a group of several banks or financial institutions under the documentation prepared by the lead bank, which takes the responsibility of arranging the loan, in order to finance a single borrower with common appraisal, common documentation, and joint supervision. The Bank and the other members of the syndicate/consortium undertake to lend specified shares of the total loan amount and the debt service is shared among all the lenders on a pro rata basis.

However, the Bank should be highly selective in terms of participating in syndications. Lead times for such facilities should be extended to match Bank-led operations. If possible, the Bank should seek to take part in syndication deals from the early stages of the syndication

process to be able to contribute to the structure of the deal. The pertinent collective decision-making requirements should be highlighted, and control in decision-making process should be targeted.

To the extent possible, and except in cases where (i) the project has significant mandate fulfillment content, or (ii) the financing agreement would not be finalized without the Bank's contribution, the Bank should normally avoid joining a syndicate/consortium in the final stages, and just in order to fill a minor remaining financing gap.

v) *Assignments*

Similar to the participation technique mentioned above the Bank may fully underwrite a loan and later sell part of it to commercial banks or other financial institutions. However, in contrast with the similar participation technique the Bank assigns the loan to a commercial bank and this commercial bank enters into direct relationship with the borrower. The Bank ceases to be a lender of record and the assignee bank does not share the preferred creditor status of the Bank.

7.3 Equal Ranking

In its lending transactions, the Bank should normally rank at least equal to other lenders. The Bank may agree, under certain conditions, to accept longer maturities or a subordinated position if this substantially enhances the possibility of securing financing for a project and increases its expected return.

Previous Version (03.00)	***Current Version (04.00)***
3.1 Total portfolio limit (Gearing Ratio) This Gearing Ratio corresponds only with the Ordinary Capital Resources, thus excluding Special Fund resources and related operations. Special Fund resources and related operations will be administered to the specifications of donor entities.	**3.1 Total portfolio limit** (Gearing Ratio) In addition, in order to secure a ratio of shareholder funds to the outstanding portfolio of active operations of 30%, the Bank establishes an operational targetset at 100% of the sum of (i) the Bank's unimpaired paid-up capital and the usable portion of callable capital, (ii) reserves and surpluses, and (iii) the amount of reserves and surpluses times the ratio of the Bank's usable portion of callable capital to the Bank's unimpaired paid-up capital[6]. This is referred to as the 'Operational Gearing Ratio'. -- [1] By way of explanation, given the 30% paid up/ 70% callable ratio of the Bank's capital, this ratio stands at 70/30, or 7/3, following the final scheduled payment of the 2008 capital increase at end 2018. -- Outstanding' amounts refer to the operational portfolio of the Bank created as a result of its banking activities, not the portion of the Balance Sheet managed by the Treasury.

[6] By way of explanation, given the 30% paid up/ 70% callable ratio of the Bank's capital, this ratio stands at 70/30, or 7/3, following the final scheduled payment of the 2008 capital increase at end 2018.