

## **Financial Policies**

---

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

## **1. INTRODUCTION**

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

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

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

Chapter 4 sets up the credit risk management policy.

Chapter 5 covers the Assets and Liabilities Management.

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

Chapter 7 covers Pricing Policy.

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

Chapter 9 sets the Guidelines for the Borrowing System.

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

Chapter 11 covers issues of Corporate Governance.

---

<sup>1</sup> The Bank has 2 kinds of operations: the operations financed from its Ordinary Capital Resources - "ordinary operations" - and operations financed by Special Funds Resources - "special operations" (article 10 of the Establishment Agreement).

## **2. PRINCIPLES OF FINANCIAL MANAGEMENT**

The Financial Policies of the Black Sea Trade and Development Bank establish the guiding principles for sound financial management.

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

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

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

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

### **Financial Viability**

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

### **Market Orientation**

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

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

The Bank's revenue orientation is also reflected in its Treasury management. The Bank's liquid assets and liabilities will be managed in conformity with the Bank's policy guidelines. Within this framework the Treasury will apply the best available knowledge and techniques for reconciling the Bank's need for generating revenues with the necessity not to incur unnecessary risks and costs. Benchmarks are to be established with respect to both the investment return on its liquid assets and the cost effectiveness of its borrowing program.

The Bank will measure the performance of its activities and asset categories by using a management accounting system that allows for attributing to each activity and asset class the revenues it has generated and the direct costs incurred by it, including the provisions that had to be made for specific nonperforming assets.

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

### **Comprehensive Risk Management<sup>2</sup>**

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

By virtue of its Mandate, the credit risks inherent in the Bank's ordinary operations are relatively high, due to the geographic concentration of its operational portfolio and the nature of the Bank's involvement in the projects it undertakes in conformity with article 2 of the Establishment Agreement. The application of sound banking principles in the Bank's credit process seeks to ensure that these significant credit risks are properly identified and managed while other risks resulting from its ordinary operations should be mitigated to the extent possible. The Bank's policy of additionality ensures that it will never take the full risk on one project. Thus sharing risks with a number of co-financiers and/or co-investors will mitigate risk.

Since the Bank's ordinary operations are inherently relatively risky, the management of Treasury activities is more<sup>3</sup> conservative. A comprehensive risk management framework for Treasury activities, particularly addressing credit and market risk, is to be established. Risks in other assets are mitigated on a pro-active basis; any soft element in such assets should be provisioned against appropriately. Deteriorating assets will be handled in accordance with the Bank's remedial policies.

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

---

<sup>2</sup> Amended with BoD Dec. 0555

<sup>3</sup> Amended with BoD Dec. 0781

Operational risk management encompasses identification, assessment, monitoring and mitigation/control of the operational risk inherent in all material products, activities, processes and systems. In the context of the Bank activities operational risk refers to the risk of loss resulting from internal events such as inadequate or erroneous human action, failed internal processes and systems, or from external events. Appropriate organizational structure, policies and procedures shall be established to address all aspects of operational risk to which the Bank is exposed.

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

### **Transparency, Accountability and Effective Corporate Governance**

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

## **3. CAPITAL, NET INCOME, AND RESERVES**

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

### **3.1 The Bank's Authorised Capital Stock**

Article 8 of the Agreement recognises as Ordinary Capital Resources:

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

As specified in Article 4 of the Agreement Establishing the Bank, the Bank's initial authorised capital stock is SDR 1 billion. The initial capital stock has been fully subscribed. It is divided into:

10% fully paid-in shares

20% shares, paid-in by promissory notes<sup>4</sup>

---

<sup>4</sup> The promissory notes are payable in 8 equal annual installments at par value.

70% unpaid but callable shares.

The aggregate par value of the initial authorised fully paid-in shares is SDR 100 million; that of the capital paid-in by promissory notes is SDR 200 million.

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

### **3.2 Limitations on the Use of the Bank's Capital**

The BSTDB Establishing Agreement places a number of institutional limitations on the use of the Bank's capital for its ordinary operations. Treasury investments, i.e. management of the Bank's liquid assets, important as they are in any banking operation, are considered auxiliary to the Bank's ordinary operations. The Bank does not consider them to be a fully independent operation within the Bank. Consequently the Bank will not generally<sup>5</sup> allocate a separate budget to Treasury investments. For investment in Member State Bonds the Bank may decide to allocate a budget.<sup>6</sup>

Article 15 of the Agreement contains a provision to the effect that the total amount of outstanding loans, equity investments and guarantees made by the Bank in its ordinary operations shall not at any time exceed 150% of the total of the Bank's unimpaired subscribed capital, reserves and surpluses included in its Ordinary Capital Resources, establishing a 1,5:1 gearing ratio. In calculating the actual gearing ratio the Bank sets-off the total of disbursements - net of cumulative repayments - and firm commitments outstanding against the actual amount of the Bank's unimpaired subscribed capital, reserves and surpluses. The ratio thus calculated should not exceed the limit of 1,5:1. The policies with regard to the gearing ratio are detailed in the Portfolio Risk Management and Investment Policies.

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

The 1,5:1 gearing ratio is a cornerstone for the Bank's financial soundness. It is especially important as the Bank is exposed to more as well as higher than average risks as it undertakes activities with a higher risk profile, in an economically rapidly evolving region, invests in enterprises in a volatile business environment and faces the risk that its customers operate in weak currency countries.

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

---

<sup>5</sup> Amended with BoD Dec. 0781

<sup>6</sup> Amended with BoD Dec. 0781

### 3.3 Capital Utilisation

The Bank is committed to an efficient use of its capital resources. A capital utilisation policy will enable the Bank to maximise the use of capital resources within the limits of its statutory gearing ratio.

A capital utilisation policy has been adopted that aims at maximising the return on capital by optimising the allocation of funds to different asset classes without neglecting the Bank's functions as stated in Article 2 of the Agreement. The Bank's Assets & Liabilities Committee will regularly review this policy.

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

#### Headroom

Headroom is defined as the difference between the statutory limit on the Bank's ordinary operations as per Article 15 of the Agreement (see Section 3. 2) and the total amount of (net) disbursed and committed loans, equity investments and issued guarantees in the Bank's portfolio. Headroom is thus a measure of the level of additional funds the Bank can commit before it reaches its statutory limit.

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

- (i) *changes to reserves and surpluses*: Any change to accumulated reserves and surpluses impacts the total amount of commitments that the Bank may enter into. As the Bank is still in its start-up stage, it cannot expect to generate significant amounts of headroom from additions to reserves and surpluses for the time being. As the Bank moves towards sustainable profitability, its retained earnings will enable it to grow its capital base (of paid-in capital, subscribed capital, surpluses and reserves) and thus generate enough headroom to autonomously fund the expansion of its asset classes. The Bank aims to be in a position within foreseeable future to generate positive net income and be able to create adequate provisions against losses on loans and equity investments as well as reserves to fund the expansion of its ordinary operations.
- (ii) *turnover of the loan and equity portfolio*: repayments on loans, equity disposals and other contributions to portfolio turnover generate additional headroom for the Bank as well. Although in the first years after starting operations the possibilities for any increase in headroom out of the portfolio turnover is necessarily limited, the Bank's commitment to maximising the use of its existing capital resources is expected to bear fruit in the medium to longer term, as the Bank's operational portfolio matures and the Bank's activities diversify.
- (iii) *currency rate fluctuations*: re- and de-valuations of the Bank's non-SDR denominated commitments also affect the level of headroom available to the Bank. As headroom is measured in SDR terms, any depreciation or appreciation of the SDR with respect to the currencies of the non-SDR-denominated portfolio

results in a change in available headroom. The Bank will devise a policy that addresses the influence of currency movements on the quality of the credits portfolio in general and on the ability of the borrowers to meeting their obligations vis-à-vis the Bank in particular.

### **Capital Utilisation Framework**

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

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

### **Portfolio Turnover**

The Bank's portfolios are expected to turn over naturally as instalments are paid on the Bank's loans and/or equity investments are sold to corporate or private investors. In addition to this normal re-flow of funds from operations, the Bank may devise a policy aimed at an active rotation of its portfolio's. Active pursuit of portfolio turnover entails a multi-faceted approach:

- *reduction of idle commitments:* The Bank continuously scrutinises its outstanding commitments in order to eliminate any idle commitments. The capital tied-up in such commitments could more efficiently be allocated to other promising operations.
- *increased raising of external funding:* The Bank places a high priority on raising external capital for the funding of its projects. The greater the success of external fundraising, the higher the number of operations the Bank will be able to finance given its capital base. The Bank will create a base of potential co-financiers in order to effectively putting together syndicates for financing big capital expenditures of its customers.

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

- *the Bank's impact on the operation:* The Bank should ensure that its role has been essentially completed. The Bank should not sell an investment<sup>7</sup> if co-financiers still perceive its role as actively engaged investor to be vital. Similarly, the Bank should refrain from exiting investments which still require an active

---

<sup>7</sup> By investment is to be understood in this paragraph: equities and loans.

involvement by the Bank in its corporate governance. Finally, the Bank should also be sensitive to (negative) reactions from customers and markets to any disposal of its investments.

- *the Bank's portfolio:* The Bank should assess the impact of the sale of its assets on the risk profile of the remaining operational portfolio. Any sale of one of the Bank's most creditworthy investments may result in a deterioration of the quality of the Bank's portfolio if the proceeds cannot be re-invested into assets with equivalent risk.
- *the Bank's net income:* The Bank should assess the impact of any asset sales on its net earnings. The proceeds from the sale of relatively high-earning operational assets will temporarily be invested in relatively low-earning liquid assets. The differential return between operational and liquid assets could result in lower income in the short term until the liquid assets are re-deployed into operational assets, which could potentially generate a lower return for the Bank than the original investments as well. Although profit maximisation is not to govern the Bank's decision to sell-off its investments, the Bank should carefully consider the impact of portfolio turnover initiatives on its net earnings.
- *the Bank's preferred creditor status:* The Bank should structure portfolio turnover initiatives so as to minimise the risk that any preferred creditor status of its loans be subjected to scrutiny.

### **3.4 Net Income**

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

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

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

#### **Income Recognition**

The Bank records interest and fees as income on an accrual basis. Accruals on loans and credits of which the payments of interest, fees and/or instalments is overdue for more than 90 days, will not be recognised as income. Any interest accrued on a loan

or credit that has been placed in non-accrual status, will be reversed out of current income.

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

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

### **Cost Recognition**

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

Movements in the Bank's provisions are recognised as cost or income as soon as actual developments in the portfolio justify an addition or a withdrawal from these provisions.

### **Delinquency**

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

- When payments of interest and principal are overdue for more than 30 days, the Bank will suspend any disbursements under current agreements to the borrower or the entity controlling the borrower, and not enter into new engagements.
- After 60 days the Bank will have the right to stop accruing interest and charges on the loan, and will consider appropriateness for application of penalties. The management of the loans et cetera to the borrower will be transferred to a specialized team within the Bank coordinated by the Project Implementation and Monitoring Department. This team will reconsider the Bank's position with the borrower, analyse the financial and economic condition of the borrower and its forecasts, and - when taking into account the Bank's policy guidelines on this

matter<sup>8</sup> - consider if a re-scheduling of the loan, a restructuring or other measures aimed at improving the chances of recovery are indicated. The possibility of a work-out solution is contemplated and the Bank establishes a working relation with the client on this basis.

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

### **3.5 Reserves and Surpluses**

#### **Reserves<sup>9</sup>**

Reserves represent the internal generation of capital through retention of earnings. These are free and unencumbered by any specific claims to qualify as shareholder funds, and thus supplementing the share capital. Reserves are a component of primary (first tier) capital<sup>10</sup>. Reserves are the ultimate protection of the Bank's capital against impairment resulting from credit risk losses in excess of provisions or losses due to market, operational and compliance risks.

The Bank targets a level of profitability guided by the desire to build an appropriate cushion of reserves against the risks inherent to its normal operations and subsequently to grow its capital base consistent with the Bank's financial and growth objectives.

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

In addition to building up a cushion of reserves, retained income will enable the Bank to maintain the real value of its capital funds and increase its investment headroom through internally generated funds. Therefore, once the Bank has accumulated the minimum target of reserves, profitability margin target will be considered in light of

---

<sup>8</sup> See paragraph 5.2

<sup>9</sup> Amended with BoD Dec. 0555

<sup>10</sup> Reserves are shareholder funds and should not primarily be looked upon as available for covering losses. They are only in last resort to be used as a buffer against losses.

the desired real growth in the volume of its operations, net of any re-flows from the turnover of the portfolio.

### **Surpluses**

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

## **4. CREDIT RISK MANAGEMENT**

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

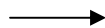
The Bank is exposed to credit risk in both its ordinary operations and its Treasury activities. Credit risk arises since Treasury counterparties could default on their contractual obligations or the value of the Bank's investments in debt securities could be impaired. The majority of credit risk is in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

All of the credit risk management framework components inter-relate with one or more of the other components. These interrelationships are addressed in the Operations Cycle and Portfolio Risk Management and Investment Policies documents, and detailed in the Credit Risk Manual, an internally approved document. Bank Management is responsible for installing and maintaining all framework components – with four principal areas of focus:

**AREAS OF FOCUS**

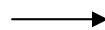
**CREDIT RISK MANAGEMENT**

ORGANIZATION



Organizational units in place with the responsibilities and authorities needed to perform strategic and tactical credit risk management activities

KSAEs



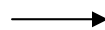
Relevant organizational units staffed with managers and professionals possessing the requisite credit risk management knowledge, skills, attitudes and experience (KSAE)

PROCESSES



A complete, well developed set of credit risk management, processes and functions in place and functioning

Management  
Information System



Requisite quantitative and analytical information available to strategic and tactical risk management decision makers

Within and in support of this credit risk management framework, BSTDB develops further policy and operational documents to cover the following:

- ◆ **Establish a full set of operational portfolio management parameters** (limits, targets, guidelines) to control the bank's exposures with respect to:
  - ◇ Country
  - ◇ Single obligor
  - ◇ Single Project

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

- ◆ **Establish exposure guidelines** that specify:
  - ◇ The kinds of credit risks that the bank will take
  - ◇ Target market guidelines
  - ◇ Risk asset acceptance criteria
- ◆ **Implement a robust operation analysis process** that specifies:
  - ◇ Financing criteria across which individual obligors/potential obligors are measured (credit quality factors)
  - ◇ Due diligence

- ◇ Evaluation standards for each financing criteria
- ◇ How to structure an operation
- ◇ Contents of an acceptable financing approval package
- ◇ Indicators for early detection of problems
- ◇ Relationship profitability/performance targets
  
- ◆ **Establish an operation approval process** that sets limits/guidelines for:
  - ◇ Approval of new operations
  - ◇ Rollovers of existing facilities
  - ◇ Risk classification of operations
  - ◇ Approval of remedial strategies
  - ◇ Approval of restructuring/rescheduling plans
  
- ◆ **Establish guidelines for operational portfolio provisioning** with respect to:
  - ◇ Specific provisions, in conformity with section 10.3
  - ◇ General provisioning for portfolio level risks
  - ◇ Write off standards and procedures
  
- ◆ **Specify standards of operations administration** to include:
  - ◇ Operations booking procedures
  - ◇ Accounting standards
  - ◇ Documentation standards
  - ◇ Operational reporting standards
  
- ◆ **Implement a risk asset rating system** that:
  - ◇ Assigns risk ratings based on specified quantitative and qualitative assessments
  - ◇ Is tightly linked to other credit risk management processes (e.g., approval, workout, audit, monitoring)
  - ◇ Triggers specific actions at specific risk rating levels
  
- ◆ **Establish a portfolio monitoring process** that specifies:
  - ◇ Risk assets review frequency (by risk rating)
  - ◇ Risk assets review standards (by risk rating)
  - ◇ Collateral valuation requirements
  - ◇ Early warning signals for asset quality deterioration
  - ◇ Account profitability/performance review standards
  
- ◆ **Establish a pro-active and robust process for managing nonperforming assets**, to include:
  - ◇ A portfolio analysis process
  - ◇ Designing and implementing remedial strategies/action plans
  - ◇ Monitoring standards

- ◇ Collateral handling processes
- ◇ Restructuring/rescheduling guidelines
  
- ◆ **Put a robust credit MIS and operation cycle exposure management system in place** that tracks credits and provides strategic, tactical and operational information at:
  - ◇ Portfolio level
  - ◇ Borrower group level
  - ◇ Individual obligor level
  
- ◆ **Put in place a strong audit process** with the capabilities to:
  - ◇ Independently evaluate asset quality and risk classifications
  - ◇ Assess performance against and adherence to established policies, processes, limits, targets and guidelines

### **Portfolio Diversification**

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

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

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

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

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

### **Risk Mitigation**

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

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

### **Organisational Responsibility**

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

- ◆ President
- ◆ Vice Presidents

taking decisions by consensus, and 2 members:

- ◆ Secretary General
- ◆ General Counsel,

taking part in the works of the Committee.<sup>11</sup>

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

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

- ◆ Considering for approval trade, corporate and project related financing applications and rollovers
- ◆ Establishing specific parameters (policies, limits, targets, guidelines) within which tactical and operational credit decision making must take place
- ◆ Approving changes to the manuals that prescribe how operations are to be analysed, approved, administered and monitored
- ◆ Approving remedial management strategies, restructurings and reschedulings for problem operations

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

- ◆ Making their own assessments of the nature and extent of the Bank's credit risk exposure
- ◆ Tracking the Bank's exposures vs. Credit Committee/Board specified policies, limits, targets and guidelines
- ◆ Reporting deviations from strategic/tactical limits, targets and guidelines to Banking Division management and the Credit Committee

---

11 Amended with BoD Dec. 0792

- ◆ Providing regular analytical support to the Bank's strategic (Credit Committee /Board) and tactical (Banking Division management) decision makers
- ◆ Making specific recommendations to the Credit Committee on changes to credit risk management parameters

The Operations Cycle document describes in detail the operational aspects of responsibilities related to origination, preparation, analysis, administration, supervision, monitoring, and workout.

## **5. ASSETS AND LIABILITIES MANAGEMENT (ALM) (Management of Market Risks)**

The Bank is, like all banks, exposed to a range of market risks associated with both its on and off-balance sheet activities. In the course of its operations, the Bank will be exposed to foreign exchange risk, liquidity risk, interest rate risk, credit risk, and other market risks, on a regular basis. The objective of ALM is to ensure that these risks are managed effectively and not allowed to negatively impact the Bank's ability to meet its financial obligations promptly. Another purpose of ALM is to improve the Bank's earnings and to safeguard the Bank's capital. Consequently, the Bank's management is expected to actively manage the Bank's market risks in accordance with a robust ALM system. Assumption and management of credit risk on financing activities is inherent to both the Bank's stated purpose and execution of its mission and is explained in detail in chapter 4 – Credit Risk Management.

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

- 1) All relevant data are available,
- 2) Organisational units exist with specific responsibilities for:
  - Making ALM decisions at strategic, tactical, and operational level (e.g. Assets & Liabilities Committee, Treasury)
  - Providing ALM decision makers with the MIS<sup>12</sup> required for informed decision making (e.g. Risk Management Unit and result monitoring)
  - Executing ALM processes on a day to day basis (e.g. Treasury)
- 3) Managers and analysts have the skills needed for successful ALM decision-making and execution.
- 4) A robust MIS capability is in place that quantifies ALM exposures and facilitates effective ALM decision making at strategic, tactical, and operational levels.
- 5) Clearly articulated risk parameters are established within which all ALM activities must take place with respect to management of the Bank's foreign exchange risk, liquidity risk, interest rate risk, other market risks, credit risk.<sup>13</sup>

---

<sup>12</sup> Management Information System

<sup>13</sup> Credit risk assumed in Treasury Operations

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

### **5.1 The Bank's Approach to ALM Risk Management**

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

- 1) *Foreign Exchange Risk*: As a matter of policy, the bank will strive to maintain a matched foreign exchange book and the ALCO's foreign exchange risk management parameters must reflect this. The guiding principles will be as follows:
  - The Bank's open position will be monitored daily by the ALM unit of the Finance division.
  - The Bank will not take significant discretionary (own account) foreign exchange position.
  - The costs associated with hedging activities will, in principle, be borne by the borrowers whose loan currency requirements necessitate hedging.
  - It is understood that the Bank's equity investment portfolio may involve exchange risks in member country currencies that may occasionally not be hedgeable at reasonable cost; however, these exposures will be closely monitored and hedged when cost-effective vehicles are available.
- 2) *Liquidity Risk*; discussed in detail in Chapter 8 of these Financial Policies
- 3) *Interest Rate Risk*: As a matter of policy, the Bank will strive to immunise its balance sheet to the extent feasible from the effects of interest rate movements and Assets & Liabilities Committee's interest rate risk management parameters must reflect this. The cornerstones of the Bank's interest rate policy will be as follows:
  - The Bank's interest rate exposure will be monitored daily by the ALM unit of the Finance division.
  - The Bank will not take significant discretionary (own account) interest rate positions.
  - The costs associated with hedging activities will, in principle, be borne by borrowers whose interest rate bases requirements necessitate hedging.
- 4) *Credit Risk on Treasury Operations*: assumption of credit risk within the Treasury will be kept to a minimum and restricted to counterparties and investments rated investment grade by a major credit rating agency. The methodology for establishing credit<sup>14</sup> exposure limits will be determined by ALCO and

---

<sup>14</sup> Inserted with BoD Dec. 0781

implemented and monitored by the Risk Management Department. As an exception to this

policy the Treasury may, subject to a Board of Directors approved credit approval process, make investments in bonds issued by the Member States or by entities originating in the Member States.<sup>15</sup>

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

## **5.2 Management and Measurement of ALM Risks**

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

- President
- Vice Presidents<sup>16</sup>

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

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

## **5.3 ALM and Analytical Support**

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

---

<sup>15</sup> Inserted with BoD Dec. 0781

<sup>16</sup> Amended with BoD Dec. 0792

<sup>Note</sup> A mark to market policy requires that the values of relevant balance sheet items be regularly adjusted, through appropriate Profits & Loss accounts, to reflect their actual market values.

- Making their own assessments of the nature of the bank's risk exposure in the five key ALM risk areas.
- Tracking the bank's exposures vs. ALCO and Treasury specified policies, limits, targets and guidelines.
- Reporting deviations from strategic/tactical limits, targets and guidelines to appropriate levels of Treasury management and ALCO.
- Providing regular analytical support to the bank's strategic (ALCO) and tactical (Treasury) ALM decision makers (e.g., monthly ALCO/Treasury reports packages)
- Maintaining and operating the Bank's ALM analytical software (e.g., Duration, Value at Risk)
- Making specific recommendations to ALCO/Treasury position managers on changes to ALM strategies and tactics
- Undertaking special ALM studies/projects at the request of ALCO and Treasury management
- Ensuring that decisions taken by ALCO are promptly communicated throughout the Bank.

## **6. TREASURY OPERATIONS**

### **General**

Treasury conducts its activities within a comprehensive framework provided by the Financial Policies, the Treasury Investment Authority, the Treasury Investment Guidelines<sup>18</sup>, the Liquidity Policy and the Borrowing Program issued by appropriate level of authority. In its daily operations the Treasury is bound to the limits on counterparty risks, country and currency risks established by the Bank's ALCO. The setting-up of the control system for the Treasury is the responsibility of the Bank's management. The individual traders are required to observe the limits fixed individually by ALCO and issued by the President.

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

### **Objectives and Principles**

The primary objective of Treasury operations is to effectively manage the Bank's liquid assets in order to safeguard the Bank's liquidity<sup>19</sup>, protect its capital and generate a financial return. In its start-up stage the Bank aims at a return that will be sufficient for covering its costs and expenses.

Safeguarding its liquidity is vital for any banking operation and puts constraints on the Treasury's asset management policies. ALCO supervises the Treasury's asset management policies and provides it with any input that it deems to be necessary.

---

<sup>18</sup> the Treasury Investment Guidelines document is incorporated into the ALCO approved Asset, Liability and Financial Risk Management Manual (ALFRM)

<sup>19</sup> Under "liquidity" be understood the Bank's capacity to always promptly meet all its obligations and commitments.

The protection of the Bank's capital being another key responsibility has as a consequence that the Treasury does not seek to maximising, but to optimising the return on its investments in accordance with the policy constraints.

The Bank's Treasury activities are auxiliary to its core business. Although being a profit centre, the Treasury is appraised primarily on the execution of its main tasks, secondly on the profits it has generated.

### **Investment Policy**

The eligibility of a Treasury investment is determined by:

- the balance of the Bank's expected payments on receivables - including borrowings - and disbursements,
- the financial standing of the counterparty measured by its credit rating issued by at least one leading credit rating agency,
- the expectations on short term developments in the relevant Money Markets, based on the most recent forecasts<sup>20</sup>,
- the macro-economic situation in the country of the counterparty, based on the most recent forecasts<sup>21</sup>,
- the Bank's total exposure to currency<sup>22</sup> risks.

Special attention will be paid to the accumulation of risks per country, per currency and per counterparty. The underlying and total risk of any Treasury investment must be eligible and measurable.

### **Currency Policy**

As the Bank's authorised capital is denominated in SDR's, the Treasury may invest in assets denominated in all its constituent currencies. ALCO will issue limits to the composition of the portfolio liquid assets according to currency.

Article 6, paragraph 5 of the Establishment Agreement grants each Member the right to paying-up to 50% of its shares in its local currency. The Bank will adopt the policy of managing these resources in the normal course of the management of the liquid assets portfolio, avoiding to the extent possible open positions for minimising the risk. Under the circumstances this policy may have as a consequence that a part of or the whole balance of such funds denominated in local currency may be converted into SDR-currencies, including the Euro, whenever appropriate terms will be provided by the market.

---

<sup>20</sup> Amended with BoD Dec. 0792

<sup>21</sup> Amended with BoD Dec. 0792

<sup>22</sup> Another word for currency is foreign exchange (abbreviation, "Forex")

Article 20 of the Establishment Agreement, dealing with the denomination of transactions, states that the Bank's foreign currency facilities shall be denominated and payable in the currencies of which the SDR is composed. All foreign currency obligations to the Bank shall be discharged in freely convertible currency acceptable

to the Bank. The Bank's national currency facilities shall be denominated in the local currency of the Member State concerned. The rate of return of these transactions shall not be under those of similar transactions in international financial markets.

The Bank will adopt policy guidelines for managing and - if and when possible - minimising the currency risks incurred by its financing of operations in Member States. The primary aim is to neutralising these currency risks by seeking local funding for these investments under appropriate terms. In case that local funding is not possible, the Bank aims at providing the financing denominated in SDR currencies. The impact of hard currency financing in a weak currency country on the debtor's ability to always meeting its obligations, will have the Bank's special attention.

### **Investment Authority**

Treasury investments are governed by two official documents in the framework of the Financial Policies:

1. The "Treasury Investment Authority" is approved by the Board of Directors on the recommendation of the President, and
2. The ALFRM document (incorporating the Treasury Investment Guidelines) approved by ALCO and issued on the basis of the "Treasury Investment Authority."<sup>23</sup>

Together, these two documents define operational constraints for the management of the Treasury investment portfolio.

The Treasury Investment Authority document provides the framework for the efficient management of Treasury investments within defined risk constraints. The Treasury Investment Authority defines the risk parameters to be observed by the Bank:

- in managing its liquid assets,
- in selecting eligible investment transactions in the Money Markets and Foreign Exchange Markets,
- in defining minimum credit standards to be applied to counterparties in investment transactions.

The Treasury Investment Authority provides rules on measuring and limiting interest rate risks, credit risks, country risks, and currency risks. It gives rules on the use of derivatives in risk management, and directives on the preferred term-structure of the Bank's funding as related to the term structure of the Bank's liquid assets portfolio.

---

<sup>23</sup> Amended with BoD Dec. 0781

The Treasury Investment Authority also delineates the organisational framework of the Treasury and its operations, the separation of functions, and the attribution of authorities and responsibilities. A separate part of the Treasury Investment Authority

issues the Bank's Code of Ethics and Code of Conduct to be complied with by the Treasury's staff in their daily operations on the financial markets. The Office of the Internal Auditor controls the compliance of the Bank's staff with the stipulations and behavioural rules laid down in the Code of Ethics.

The "Treasury Investment Authority" allows the Bank to appoint external advisors to act as external asset managers for part of its liquid asset portfolio. The external asset managers will be tied-up to the Bank's investment objectives and principles by specific clauses in the Mandate issued to them by the Bank.

The "Treasury Investment Authority" is regularly reviewed by ALCO and approved by the Board of Directors on recommendation of the President.

#### **ALFRM document (Incorporating the Treasury Investment Guidelines)<sup>24</sup>**

The ALFRM implements the rules and directives laid down in the Treasury Investment Authority. It provides detailed instructions on the key operational aspects of risk management, portfolio management, liquidity management and Money Market and forex operations. It operationalises the organisational framework set by the Treasury Investment Authority, details the monitoring of the daily operations and the supervision on the staff's compliance with the Bank's rules and Code of Ethics.

ALCO approves the ALFRM following a proposal submitted to it by the Vice President Finance. It is regularly reviewed and adapted to the actual business environment conditions.

#### **Use of Derivatives**

Derivatives are contracts between two parties to buy / sell an agreed quantity of paper<sup>25</sup> against payment of a certain price, delivery dependent on a separate, additional action by the buyer. The actual value of the derivative is the value embodied in the delivery obligation, which changes with the market value of the underlying assets. Derivatives include inter alia futures, options, swaps, forward rate agreements, and combinations thereof.

---

<sup>24</sup> Both paragraphs amended with BoD Dec. 0781

<sup>25</sup> Under "paper" is understood the paper document that embodies a financial asset, such as a share, an obligation, a right, a basket of shares or bonds representing a market index, or a certain quantity of commodities. This enumeration is not meant to be exhaustive.

The Treasury Investment Authority restricts the use of derivatives to the protection of the value of the Bank's assets. It strictly forbids taking and/or maintaining open positions<sup>26</sup>.

In the area of treasury risk management the Bank is committed to following industry best practice. The Bank complies fully with all requirements relevant to end-users.

The Bank is committed to full disclosure of its derivatives position in the Annual Report and the quarterly financial reports to the Board of Directors.

## **7. PRICING POLICY**

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

### **Pricing Principles**

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

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

- ◆ Basic principle: The Bank's pricing policy reflects the fundamental principles of market pricing and recovery of operating and capital costs associated with transactions.
- ◆ Pricing components: These components include the base rate, margin, commissions and fees.
- ◆ Pricing is structured flexibly bearing in mind the different characteristics of individual transactions. Specifically, in the context of market pricing and recovery

---

<sup>26</sup> An "open position" is a position in derivatives without the Bank having the underlying assets. When the Bank's vision turns out to have been wrong, the Bank will sustain a loss by the (negative) margin between the price agreed upon and the actual market price at the assignment date.

of operating and capital costs, the Bank typically considers the following factors in determining margins and fees (not necessarily in order of importance):

- ◇ Market pricing
- ◇ Compensation for credit risk
- ◇ Collateral and other security
- ◇ Charge for undisbursed funds
- ◇ Administrative expenses
- ◇ Return on capital.

### **Base Interest Rates**

Pricing for loans consists of the base interest rate linked to Libor, or equivalent benchmark for actively traded currencies, and adjusted for the cost of funds, if appropriate.

### **Pricing Margins**

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

- ◆ Transaction specific risks are based on an assessment of risk factors affecting an obligor's commercial viability and the availability of collateral or other security. Pricing of these risks is normally set on the basis of the best estimate of the average risk during the life of the operation. As part of standard practice, important points which arise relating to a loan's risk profile will be highlighted in loan documentation.
- ◆ Country specific risks are based on the potential impact on probability of default of economic developments. The Bank distinguishes differences in country risk by using economic risk indicators based on credit assessment consistent with those of several leading external sources.
- ◆ The Bank utilises a risk rating system to signify the relative credit quality of the Bank's assets. The risk rating is the main determinant for the classification of loans, and thus the aggregate quality of the Bank's operational portfolio may have correspondence in pricing individual operations.
- ◆ In addition to country and project risk, several other factors may be reflected in the margin, such as an adequate allowance for return on capital, etc.

### **Commissions and Fees**

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

## **Delegation of Pricing and Reporting to Board**

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

## **8. LIQUIDITY POLICY**

### **General**

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

The liquidity policy of the Bank aims at balancing the term structure of the Banks' financial assets and liabilities in such a way that it allows for a smoothly running of its business. The Bank is an international financial institution funded by shareholders equity and capital market instruments such as bond loans, Euro-currency loans, certificates of deposits, et cetera. For funding its short-term operations, such as trade financing, it will attract additional short term funding in the Money Markets.

The Bank's financial assets will chiefly consist of long and medium term engagements for the financing of relatively large operations. Investments in trade financing will be relatively short term. The Bank will pay due attention to the term structure of its assets and liabilities portfolio's in order to protect its overall liquidity. Liquidity allows the Bank to be flexible in establishing funding patterns, which permit to take advantage of attractive funding opportunities, and to avoid being forced to access markets in unfavourable circumstances.

The day-to-day management of the Bank's cash flows will be supported by systems that allow for continuously monitoring its actual positions. These include inter alia *per day* the balances on its accounts, receivables, disbursements, payables, in short all incoming and outgoing payments. They also produce cash flow forecasts *per day* according to the Bank's administration and an estimate of the amounts drawn-down by customers under the Bank's contingent liabilities and undisbursed but callable loans.

The Bank is committed to the "Golden Rule of Banking", thereby limiting the risk for the Bank's liquidity by as best as possible matching the term structure of assets and

liabilities portfolios. It deliberately refrains from using the “mismatch” as an additional source of income.

In order to obtain funding against the best price the Bank will initiate communication with the leading credit rating agencies as soon as it starts operations and apply for rating when appropriate.

### **Funding and Liquidity**

The objective of funding and liquidity is to realise the best funding against the lowest funding costs, consistent with prudent and diverse sources and interest parameters.

Funding conditions are subject to continuous change. Some of the factors that exert influence on the funding conditions are:

- The Bank’s balance sheet, its composition and size, growth targets and asset mix
- Maturity and liquidity of the Bank’s portfolio
- Diversity of sources of funding
- Financial performance
- Economic conditions in the Black Sea region
- Changes in the bank's investment policies
- Quality of corporate governance.

### **Assets and Liabilities Management**

In its assets and liabilities management, the Bank pursues three key policy aims. First, it seeks to protect itself from market risks (i.e. currency, interest rate and commodity risks). Second, within its statutory purposes the Bank seeks to attract the best diversified and most cost efficient business and projects. Third, the Bank aims to create a framework for flexible-funding activity, detached from the Bank’s asset structures.

The Bank’s assets and liabilities management is guided by the following principles. Still in its start-up stage its attitude towards market risks is conservative, and tolerance limited. Consequently the Bank is dedicated to adopt and maintain best industry practice in measuring and managing market risks. One other feature of the Banks’ assets and liabilities management is its determination to keeping the measuring and reporting of market risks strictly separate from the management of those risks. Last but not least the Bank will clearly assign responsibilities in the Treasury department for all kinds of market risks to which the Bank is exposed.

Assets & liabilities management is elaborated in chapters 5 and 6.

## **9. BORROWING POLICY**

The Bank will build-up its borrowing capacity through establishing dialogue with rating agencies, developing its profile, maintaining its presence in the financial markets and tapping funds on appropriate terms whenever such funds are available and needed for the operations of the Bank. While doing this, the Bank will take

maximum advantage from cooperation with the other co-financiers and benefit from the risk rating of these co-financiers to establish a solid reliable track record. The Bank is authorised to borrow on international and local markets according to applicable legislation in the country concerned.

On an ongoing basis, the key imperative for the Bank's borrowing policy is to maintain strong liquidity while cost effectively providing the long term funds needed to meet operational requirements. This principle will be implemented by:

- ◆ Maintaining a minimum of 50% of the next year net cash requirements including coverage of committed undisbursed operations
- ◆ Conducting the borrowing program within a multi-year context
- ◆ Operating within a target zone, above the minimum level, of approximately 90% as a guideline for the upper level

The President will present when necessary to the Board of Directors a Borrowing Program for consideration and approval. The level of borrowings will be determined in light of the Bank's operational requirements and the Bank's liquidity policy.

The Bank's borrowing program also has four important objectives:

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

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

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

The Bank will actively manage its outstanding liabilities through buyback of debt in the secondary market:

- ◆ To service investors wishing to sell the securities

- ◆ To improve the trading performance of outstanding debt
- ◆ To generate profits.

## **10. REVENUE RECOGNITION, PROVISIONING AND WRITE-OFF POLICY**

### **10.1 Revenue Recognition**

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

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

### **10.2 Policy on Loan Restructuring / Rescheduling**

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

- i) not reschedule debt payments or participate in debt rescheduling agreements with respect to its loans to, or guaranteed by, its member countries of operations; and
- ii) not reschedule its loan to a private sector borrower where the borrower's ability or anticipated inability to service its debt is due to a general foreign exchange shortage in the borrower's country.

In circumstances where rescheduling provides the best means of protecting the Bank's interest, the Bank may consider to restructure the repayment terms of existing operations to private sector borrowers. The Project Implementation and Monitoring Department submits a proposal to restructure the operation to the Credit Committee, which determines pursuant to certain general principles if the circumstances are correct and decides on the implementation of the proposal. The overriding principle ruling the decision is that restructuring turns out to be the best

out of all alternative courses of action that have been considered, including selling-off the loan and / or equity investment and the liquidation of the borrower/obligor. The Bank will never deem restructuring to be appropriate merely for avoiding a default. If the financial condition of the borrower/obligor deteriorates beyond the point of sustainability, the Bank will pursue liquidation or settlement.

The decision to restructure / reschedule the exposure will be normally made subject to the condition, that other financiers, investors and creditors of the borrower/obligor share the burden of the company's difficulties by providing additional equity, rescheduling their loans, or a combination of these, as well. The rescheduling is thus part of an overall scheme aimed at turning around c.a. revitalising the company. The

plan must enable the company to achieve financial viability, as measured by its projected ability to servicing its debts/obligations out of future cash flows.

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

### **10.3 Provisioning Policy**

#### **Purpose**

The Bank will maintain provisions to provide a cushion against risks that materialise. The level of provisions will be consistent with the character of its operational portfolio and the economic conditions in the region where its investments are located. The Bank charges income with provisions for risks associated with lending, investments and other banking activities, which may include risk of loan loss, and for specific risks identified in the portfolio.

Provisions are constituted on a gross basis. Provisions may be treated either as a liability or as a counter asset (reducing thus the total value of assets with the amount representing identified potential impairment).

Procedures and processes for determination, constitution, addition to and release from provisions will be presented in detail in internally approved documents issued in implementation of the Provisioning Policy

#### ***General provisions***

General provisions do not relate to any specific exposure as a yet identified problem<sup>27</sup>. They protect against unforeseen risks in the portfolio. The level of the general provisions reflects the probability that a percentage of the total portfolio will ultimately prove unrecoverable.

---

<sup>27</sup> General provisions represent the risk of financial loss due to unidentified risks over the entire portfolio and are not associated with, and charged on, individual operations. However, the appropriate level of general provisions needs to be constituted from interest income, and therefore the risk margin component of the interest rate charged on each operation shall have correspondence with the provisioning rate.

Each operation in the portfolio shall make a contribution to general provisions, according to its country and project risk as determined at the time of approval of the operation. Allocations to general provisions are made from income regularly during the fiscal year. Allocations from the year-end profit may occasionally be made, when considered that the level of general provisions falls short of what may be safely considered an acceptable cushion for the overall risk in the portfolio.

No releases from general provisions shall be made to income prior to meeting the target established by this policy.

### ***Specific provisions***

Specific provisions are funds set aside to account for the likelihood of impairment of specific exposures, and have a direct relation to the asset whose likelihood of impairment they cover. They shall be made for each asset where specific problems have been identified, with a view to compensating proportionally for the risk that the Bank may not be repaid in full the outstanding financing.

Specific provisions against potential losses will be formed as a result of a risk asset review process. Reviews will be executed at least 2 times per year, at the same time as the Bank's financial statements are prepared.

Additions to and withdrawals from specific provision are made as soon as such review concludes it to be appropriate, or at the time a change in the risk of an individual exposure is identified. Releases from specific provisions shall normally be transferred to income.

### **Provisioning Target**

The Bank will in the course of the years, gradually make additions to the general risk provision. The target set by the Bank is for the general provisions to reflect the probability that a percentage of the total portfolio will ultimately prove unrecoverable. The level of general provisions should be, to the extent possible, matched against the appropriate corresponding risk of outstanding exposures less the gross value of non-performing assets<sup>28</sup>.

### **Provisioning Tools**

To assist in evaluating the appropriate level of specific provisions, the Bank may build on:

- The use of a provisioning matrix based on risk rating categories for calculating provisions against risky assets: this system recognises the relative strengths and weaknesses of different operations by assessing the credit risk of each asset and assigning it to a risk rating category.

---

<sup>28</sup> The target has been set according to the overall risk characteristics of the region of operation, the small number of operations in the portfolio, the relatively significant impact each operation has on the entire portfolio, and the high sectoral concentration of the portfolio.

- The differentiation by instrument category within the provisioning matrix, divided into debt (including guarantees) and equity. The rationale for assigning different percentages for debt and equity is that in the event of project failure, the loss to the Bank is likely to be notably higher for equity than for debt.

### **Miscellaneous**

The Bank's provisioning policy shall be reviewed in light of the Bank's growing experience and the economic developments in the Black Sea region.

The Bank discloses the amount of provisions in the Bank's Annual Report and the financial reports to the Board of Directors.

### **10.4 Policy on Write-offs**

#### **Private Sector Assets**

The Bank will take appropriate measures according to internally approved rules and procedures to workout non-performing assets through all possible means before deciding to write-off the remaining not recovered exposure.

The Bank will write-off any remaining exposure against the provision only after it has determined that there are no credible chances that the client will be able over a reasonable period of time (e.g. liquidated) to repay any remaining obligation, and that the exposure must be considered unrecoverable. Any revenue to the Bank from a written-off exposure irrespective of its origin (call of guarantee, use of collateral, exercise of security, payment by owner/sponsor, etc.) shall be recognised at time of receipt as exceptional income.

#### **Sovereign-guaranteed Assets**

The Bank will not participate in debt rescheduling or debt reduction exercises of sovereign-guaranteed assets without previous consult with the guarantor. It will cooperate in such operations when its position as borrower and/or investor and the risk-profile for the Bank are not impaired.

## **11. CORPORATE GOVERNANCE**

### **Basic Principles**

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

## Governing Structure and Responsibilities

The Bank's governing constitution is BSTDB Establishing Agreement, which provides that the Bank will have a Board of Governors, a Board of Directors, a President, Vice Presidents and staff.<sup>1</sup>

All the powers of the Bank are vested in the Board of Governors.<sup>2</sup> With the exception of certain reserved powers, the Board of Governors has delegated the exercise of its powers to the Board of Directors while retaining overall authority.

Subject to the Board of Governors' overall authority, the Board of Directors is responsible for the direction of the Bank's general operations and exercises the powers expressly assigned to it by the Agreement and those powers delegated to it by the Board of Governors.<sup>3</sup>

- ◆ The Board of Governors elects the President. The President is the Chief Executive and legal representative of the Bank and, under the direction of the Board of Directors, the President conducts the current business of the Bank.
- ◆ The President is the chairman of the *Management Committee*. This Committee consists of the President, Vice-Presidents, and the Secretary General. It considers all key aspects of the strategy, performance and financial soundness of the Bank.

The Board of Directors establishes the *Audit Committee*. The membership of the Audit Committee consists of:

- ◆ 3 BSTDB Directors (on a one year, rotating basis)

This committee reports directly to the Board of Directors.

The Board of Directors has also established four special committees:

- Assets & Liabilities Committee (see Chapter 5 of these policies)
- Credit Committee (see Chapter 4 of these policies)
- Recruitment Committee
- Purchasing Review Committee

Additionally, specialised committees may, in due course, be established by authority of the President to facilitate strategic and important tactical level decision making within the Bank, for example:

- ◆ Human Resources Committee
- ◆ Information Technology Steering Committee

---

<sup>1</sup> Agreement Establishing the Bank (Article 21).

<sup>2</sup> Agreement Establishing the Bank (Article 23).

<sup>3</sup> Agreement Establishing the Bank (Article 26).

- ◆ Each committee will have a specific charter specifying membership, responsibilities, authorities, etc. Other committees may be established from time-to-time at the discretion of the President.

### **Information Support**

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

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

- ◆ Operations and investment pipeline
- ◆ Administrative expenses
- ◆ Credit developments
- ◆ Financial results
- ◆ Technical cooperation

In addition, detailed information will be available to permit management to monitor the implementation of business plans and the execution of budgets. This information aims at enhancing accountability throughout the organisation.

### **Financial Planning**

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

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

The Bank's annual budgeting process is regulated by the Bank's Guidelines for Planning and Budgeting document and involves:

- ◆ A Bankwide assessment of the program objectives for the year, of costs and the budgetary outlook, and significant developments (both external and internal)
- ◆ A prospective review of the Bank's existing operational priorities which is discussed with the Board of Directors
- ◆ A set of internal planning guidelines from which each department or unit prepares its proposed objectives, work programme and resource requirements for the year.

The annual budget for direct costs will be managed centrally, with breakdowns between each of the Bank's departments, to ensure a high degree of transparency and managerial accountability. Centrally managed costs are monitored against each account on a Bankwide basis to ensure that the Bank's policies and guidelines are consistently followed.

Administrative expenses, authorisation and accountability: segregation of duties and allocation/delegation of specified responsibilities to designated staff are a tool in controlling expenses.

### **Compliance and Operational Risk<sup>29</sup>**

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

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

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

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

For the purpose of fulfillment of its activities and in order to identify and manage compliance and operational risks at an early stage, the Compliance and Operational Risk Management Office establishes cooperative relationships with other relevant organizational units in the Bank. Close co-operation is also established between the Compliance and Operational Risk Management Office and other risk management units with respect to the provision and exchange of relevant advice and information and the cumulative reporting of the compliance and operational risks.

Control of compliance and operational risk within the Bank shall rely heavily on the fundamental framework of sound banking practices, with appropriate checks and balances and segregation of duties. This framework will be based on:

- ◆ An overall culture of control and responsibility

---

<sup>29</sup> Amended with BoD Dec. 0555

- ◆ Staff of experience and high integrity
- ◆ Detailed, complete and accurate accounting and operational records
- ◆ Control over access to the Bank's assets and systems
- ◆ Compliance with established operational procedures.

### **Key Policies<sup>30</sup>**

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

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

### **Internal and External Auditors**

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

---

<sup>30</sup> Amended with BoD Dec. 0555

specific audit requests or investigations upon the request of management and the Board of Directors and also acts as coordinator with the external auditors of the Bank.

*External Auditors:* the Board of Governors appoints the External Auditors on the recommendation of the Board of Directors, for a one-year term. At the conclusion of their annual audit, the External Auditors provide a signed auditor's opinion on the truth and fairness of the Bank's Financial Statements and separate signed auditor's opinions for each of the Bank's special operations. Additionally, they prepare a Constructive Comments Letter and/or a Management Letter, setting out the Auditors'

views and Management's responses on the effectiveness and efficiency of controls. This Letter(s) is reviewed in detail and discussed with the Audit Committee. The performance of the External Auditors is subject to regular review by the Audit Committee.