6. FINANCIAL INTERMEDIARIES

6.1 INTRODUCTION

6.1.1 The Bank’s involvement in a country’s financial sector is set out in the Results-Based Country Strategy Paper (RBCSP) and driven by the Bank’s overarching poverty reduction objective. Where applicable, the RBCSP will show how the financial sector affects the country’s development prospects; it highlights reforms to be supported by Bank financial sector operations, including their sequencing; and it states why the proposed operation is an appropriate vehicle for Bank support for reforms. As appropriate, the Bank consults with the IMF, the World Bank, and selected donors on its proposed financial intermediary lending, and it coordinates its financial sector strategies and operations with theirs.

6.1.2 One form of Bank’s intervention in the financial sector is a Financial Intermediary loan (FIL). Under FILs or a FIL component of an investment loan, the Bank provides funds to eligible participating Financial Intermediaries (FIs) for onlending to final borrowers at the FIs’ risk. The objective of such lending includes: (i) supporting reform programs in the financial sector or related real sectors; (ii) financing real sector investment needs; (iii) promoting private sector development, including helping to stabilize, broaden, and increase the efficiency of private financial markets and their allocation of resources and services; (iv) promoting the development of the participating FIs; and (v) supporting the country’s poverty reduction objectives.

6.1.3 FILs are provided in the context of sound analytical work on sector issues, appropriate technical assistance, and, as relevant, adjustment operations to address policy issues. The Bank’s intervention in the financial sector may also be in the form of other lending instruments (e.g., structural and sector adjustment loans and technical assistance loans), guarantees, and non-lending activities (e.g., country economic and sector work, training, and financial advisory services).

6.1.4 RMCs use Financial Intermediaries (FIs) to manage funds received from government, multilateral development banks (including the Bank), other donors, and the financial markets. The FIs provide loans and equity contributions to organizations in sectors, or sub-sectors, such as agriculture, industry, and small or medium-scale enterprises. FIs include commercial banks and other financial institutions. They are also known by sectoral titles, such as agricultural banks, industrial banks and housing development banks, or as development financial intermediaries, microfinance institutions (MFIs) and microfinance intermediaries.

6.1.5 FIs are expected to generate an interest rate spread (the difference between lending and borrowing interest rates) that covers all operating costs, including provisions for bad and doubtful debts, and provide a profit.

6.1.6 In addition to this introduction, this part of these Guidelines has six sections:
   - 6.2 – Reviewing Financial Management: This section describes specific issues to be considered when reviewing the financial management practices of FIs. These issues include the treatment of interest rate distortions, directed credit and subsidies.
• 6.3 – Investments: This section describes the Bank’s approach to FI investments. It discusses selection of participating institutions and appraisal approaches.

• 6.4 – Assessing Performance: This section describes considerations regarding and approaches to, measuring the performance of FIs. In particular, it advises on applying the CAMELS\(^1\) framework and assessing FI risks. The section stresses that the performance measures recommended throughout other parts of these guidelines are not necessarily applicable to FIs.

• 6.5 – Appraisal Checklist: A generic checklist is provided for appraising FIs.

• 6.6 – Reporting and Auditing Issues: This section provides specific guidance on the reporting and auditing requirements of FIs.

• 6.7 – Microfinance Institutions: This section discusses the special case of Microfinance institutions.

### 6.2 REVIEWING FINANCIAL MANAGEMENT

#### General Operational Issues

6.2.1 State-owned FIs resemble their commercial cousins in that frequently they have been formed to address the needs of a particular community, or category of commerce or industry, or branch of human activities, such as lending very small sums to urban and rural poor through microfinance. Some state-owned FIs are very large while others can be very small. There is no generic model for preparing, and appraising the capabilities and capacities to deliver a proposed project by FIs.

6.2.2 The objective of reviewing FI operational performance is to assess its ability to: (i) deliver subloans to achieve defined country/sector economic objectives; (ii) efficiently recover subloans; and (iii) cover all operating costs and make a reasonable profit on the invested capital. FIs have numerous forms of performance indicators that can provide analysts with an understanding of past and ongoing performance. Where an existing FI is the subject of a proposed project, or of a continuing Bank lending operation, the financial analyst (or investment officer) should begin by closely studying the FI’s most recent annual financial statements and associated auditors’ reports and opinions.

6.2.3 For an ongoing project, this review should be conducted against the objectives and recommended operational performance set out in the most recent AR. After drawing conclusions as to past and current performance, the financial analyst (or investment officer) should discuss their findings in detail with the project task manager and the FI management and, if appropriate with the proposed or actual borrower, and an apex institution, (where participating). Every effort should be made to reach agreement on these initial findings; particularly on management deficiencies, system defects, and performance shortcomings or failures. This first step is essential to ensure that the FI management understands and will fully support the objectives of a proposed project, or revision of objectives (where necessary) for an ongoing project. Full collaboration by FI management and their complete endorsement of a mission’s proposals is critical for the investment’ success. Any reservations by FI management or the borrower should be confirmed in the Aide Memoire and reported to Bank management.

\(^1\) Capital adequacy, Assets, Management quality, Earnings, Liquidity and Sensitivity.
6.2.4 It is particularly important to monitor the implementation and fulfilment of the stakeholders responsibilities, and the impact of their obligations on: (i) their respective national economies; (ii) performance of the institution as a borrower; (iii) national influences on regional operations (where present), and (iv) selected enterprises in representative regions of countries as sub-borrowers.

**Policy Framework for FIs and FI Loans**

6.2.5 The design and timing of FILs should take account of the prevailing and expected macroeconomic environment, including the exchange rate regime and international capital mobility, as well as conditions in real sectors. Given the critical importance of the macroeconomic and sectoral framework for financial sector sustainability and efficiency, the Bank considers FILs in the context of a satisfactory macroeconomic framework. Within this framework, the Bank uses its lending and non-lending services to focus on improving the incentive environment for FIs.

6.2.6 The Bank involvement in the financial sector of countries through FILs: (i) supports improvements in the incentives structure for market participants, including elimination of impediments to efficient resource mobilization and allocation; (ii) supports development of infrastructure, including creation and strengthening of sound and competitive financial intermediaries and markets, and improvements in financial and prudential regulations, banking supervision, and accounting and auditing standards; and (iii) aims to remove or substantially reduce subsidies, whether provided through interest rates, directed credit, institution-building grants, or otherwise. (Institution-building TAF grants and other non-interest rate subsidies may be provided in a variety of ways, for example, as preferential income-corporate tax treatment, free use of facilities, consultancies, guarantees, training, and subsidized staff costs and overheads).

**Treatment of Interest Rate Distortions**

6.2.7 The level and structure of interest rates are critical determinants of: (i) the economic efficiency with which resources are allocated in an economy, and (ii) financial sector viability. By definition, interest rates reflect the opportunity cost of capital in undistorted markets. Interest rate distortions may lead to a misallocation of resources, resulting in forgone national income. Therefore, the removal of interest rate distortions in a country is an important objective of financial sector reform programs supported by Bank-funded FILs. Interest rate reforms should be appropriately phased to minimize adverse impacts on the solvency and liquidity of FIs and enterprises.

6.2.8 When there are major interest rate distortions in a country (e.g., large interest rate subsidies, pervasive interest rate controls, or policies that cause extremely high interest rates), the Bank does not support a program until the country establishes agreed programs to remove or substantially reduce the distortions during implementation of the FIL. In determining whether there are major interest rate distortions, the following factors should be considered: (i) whether domestic interest rates are administered, are determined non-competitively, or are affected by the government’s fiscal tax/subsidy and regulatory policies; and (ii) when capital markets are open, whether there are significant differences between domestic interest rates and interest rates payable on borrowings of foreign capital (that cannot be explained by prevailing economic conditions).
Treatment of Directed-Credit Programs

6.2.9 Bank-supported FILs also aim to remove or substantially reduce the use of directed credits that are similar to interest rate subsidies, as these lead to resource allocation outside market mechanisms. However, under certain circumstances, Bank may support programs that include directed credit or subsidies. Directed credit programs supported by Bank may be channelled through specialized FIs, particularly those that concentrate their lending in certain sub-sector market niches for business strategy reasons.

6.2.10 In many countries, increasing access to credit by specific sectors (e.g., micro-finance institutions or the rural sector) is a major government policy objective, and some use directed credit to pursue this objective. A Bank FIL may support directed-credit programs to promote sustainable financing for such sectors, provided that the programs are accompanied by reforms to address the underlying institutional infrastructure problems and any market imperfections that inhibit the market-based flow of funds to those sectors. Such reforms include measures to: (i) address obstacles that impede the flow of funds to the credit recipients, or (ii) enhance the creditworthiness of the intended beneficiaries through appropriate approaches such as mutual group guarantees. When such targeted lending is commercially oriented, it is not considered to be directed credit.

6.2.11 It is good practice to routinely monitor the contribution of directed credits and their associated concessional terms to the growth of the targeted sector(s) and poverty reduction, taking into account any adverse impact on other parts of the economy.

Bank Policy on Subsidies

6.2.12 The Bank does not have a specific policy on subsidies. In some cases, however, subsidies may be an appropriate use of public funds e.g., for poverty-reduction programs. The Bank supports programs involving subsidies only if they: (i) are transparent, targeted, and capped; (ii) are funded explicitly through the government budget or other sources subject to effective control and regular review; (iii) are fiscally sustainable; (iv) do not give an unfair advantage to some FIs over other qualified and directly competing institutions; and (v) are economically justified, or can be shown to be the least-cost way of achieving poverty reduction objectives Subsidies that do not meet these tests should be phased out, or are substantially reduced, during the course of a FIL.

Eligibility Criteria for FIs

6.2.13 Bank requires assurances that FIs, acting as onlenders using FILs and other investment operations, are financially efficient and viable institutions. In particular, they must be financially sustainable – as represented by adequate profitability, capital, and portfolio quality, as confirmed by financial statements prepared and audited in accordance with accounting and auditing standards acceptable to Bank – and have: (i) acceptable levels of loan collections; (ii) appropriate capacity, including staffing, for carrying out subproject appraisal (including environmental assessment) and for supervising subproject implementation; (iii) the capacity to mobilize domestic resources; (iv) adequate managerial autonomy and commercially oriented governance (particularly relevant when state-owned or state-controlled FIs are involved); and (v) appropriate prudential policies,
administrative structure, and business procedures. Using these criteria, Bank determines the eligibility of a proposed FI, or it may require an apex institution or other appropriate entity to do so.

6.2.14 New and existing FIs that do not meet all the eligibility criteria for being intermediaries may participate in a Bank-funded FIL if they agree to an institutional development plan that includes a set of time-bound monitorable performance indicators and provides for a midterm review of progress. When an FIL includes such FIs, the size and complexity of the FIL should be commensurate with the FIs’ implementation capacity; and the FIL may include an institution-building component that the borrower may pass on in the form of grants. Such FIs’ continued participation in the FIL is subject to their satisfactory implementation of their institutional development plans; when progress is not satisfactory, Bank considers appropriate remedial action, including suspension.

6.2.15 FIs whose performance in relation to eligibility criteria has been unsatisfactory for an extended period of time are required to take substantial corrective measures and to demonstrate improvement before they are permitted to participate in a FIL under an institutional development plan as described above.

6.3 INVESTMENTS

Appraising an FI Investment

6.3.1 The Bank’s appraisal of an FIL should establish financial and economic justifications for the intervention and confirm: (i) whether it will achieve the desired objectives with due regard to the sustainability of the financial sector; (ii) for an FIL established for its poverty-reduction goals, that it is a practical, cost-effective way of achieving such goals; (iii) the eligibility of FIs proposed for inclusion; and (iv) that implementing the FIL is not likely to undermine the financial condition of participating FIs.

6.3.2 The economic analysis of an FIL should take into account the prevailing and expected macroeconomic environment and substantiate that the proposed operation will lead to net economic benefits arising from policy and institutional changes and increased availability of investment funds. If the justification for an FIL depends critically on addressing perceived market failures (i.e., non-market effects or externalities), the analysis should explain the assumptions and their empirical basis. If there is evidence of a subsidy involved in an FIL such that resources through interest rates subsidies or other means are provided below their economic opportunity cost, the extent of subsidy dependence must be calculated and assessed.

6.3.3 Risk analysis should be used to demonstrate how robust the projected economic benefits of the project are to possible changes in assumptions about the macro economy, borrower commitment to the reforms supported by the FIL, and institutional performance. Note that this reference to risk analysis should not be confused with market risk and associated indicators.

Sub-Projects

6.3.4 FILs are used to finance investments in subprojects for increased production of goods and services which should be established at the subproject level. It must be derived from
expanding existing productive capacity, increasing the efficiency of capacity utilization, or creating new types of productive capacity. The subprojects must meet eligibility and development criteria agreed with the Bank. The Bank will also agree appropriate arrangements to monitor subproject compliance with these criteria. In addition to the above criteria, the appraisal should ensure that subprojects are financially viable and technically, commercially, managerially, and environmentally sound. Working capital financing to maintain existing levels of production is not eligible for Bank financing.

**Use of Bank Funds**

6.3.5 The borrower may pass on Bank funds to a FI either as a loan or as borrower’s equity; similarly, FIs may pass on Bank funds to sub-borrowers as subloans or equity investments. In all cases, Bank funds are disbursed against eligible expenditures for goods, works, and services.

6.3.6 FILs are normally amortized by Bank’s borrowers on country specific terms as established by the Bank and not on a back-to-back basis, by earmarking sub-borrowers’ repayments for amortizing the Bank loan. The borrower may pass the funds on to FIs either on a back-to-back basis or on the basis of another amortization schedule acceptable to the Bank. When FI loan repayments to the borrower are not on a back-to-back basis, the FIs may, within their overall loan amortization schedules, use repayments for purposes that are consistent with their business strategies, or for prepayments to the borrower. Under an apex or two-tier lending arrangement, Bank funds are passed initially to an apex (first-tier) institution, which on-lends them to the participating retail financial institutions. Two-tier lending arrangements are common, but a three-tier arrangement may be feasible, particularly to address micro-credit operations. A FI with actual or potential conflict-of-interest cannot serve as an apex institution.

**On-lending Terms**

6.3.7 FIL on-lending terms are set in the context of a borrowing country’s interest rate structure and any agreed program for interest rate reforms. Bank funds are priced to be competitive with what the participating FIs and their sub-borrowers would pay in the market for similar money, taking into account relevant maturities, risks, and scarcity of capital. When interest rates are not market-determined and there is an agreed program of interest rate reforms, FIL funds are on-lent to participating FIs at interest rates agreed with the Bank that: (i) are not negative in real terms; (ii) provide adequate margins to FIs to cover all costs, including credit and other risks, and an adequate profit margin; and (iii) do not discourage resource mobilization from the market by providing a price advantage to using FIL funds.

6.3.8 Bank funds may be on-lent to participating FIs and their sub-borrowers in either foreign exchange or domestic currency on the basis of prudent credit decisions, including prospective sub-borrowers’ ability to bear the foreign exchange risk and to avoid later credit risk. Where interest rates are market-determined and there is relatively easy capital movement, local currency interest rates include an implicit premium that reflects market expectations in regard to exchange rate changes. In such situations: (i) Bank FIL funds are on-lent to FIs in either local or foreign currency, provided the on-lending interest rates are consistent with prevailing interest rates in the borrowing country for comparable
credit; and (ii) FIs normally on lend to sub-borrowers in the same currency or currencies that the FIs borrowed.

6.3.9 If interest rates are not market-determined but are set administratively, it is not possible to determine market expectations of exchange rate changes, as foreign exchange risks may be under priced in local currency interest rates. Therefore, the foreign exchange risk of FIL funds is borne either by: (i) Sub-borrowers through borrowing and repayment in foreign currency, or (ii) the government if on-lending and repayment are in domestic currency at prevailing administered interest rates. In the latter case, the government charges a fee that is passed on to FIs and sub-borrowers to offset the anticipated foreign exchange risk.

Monitoring FI Investments

6.3.10 During project appraisal and negotiations, provision is made for effective monitoring and evaluation of the FIL’s progress toward its objectives and development impact throughout the life of the project. The performance indicators agreed on at loan negotiations cover sectoral, financial, and institutional variables. The variables for FIs include among other things, adequacy of capital, quantity and quality of earnings, quality of assets, sufficiency of liquidity, extent of subsidy dependence, effectiveness of FI loan administration (appraisal, supervision, and collection performance), and adequacy and timeliness of preparation of audited financial statements. During implementation, the Bank, the borrower, and the FIs in each tier must use the agreed performance indicators, implementation progress reports, and a review of a sample of subprojects to monitor the FIL’s progress.

6.3.11 At least once each year during implementation, the Bank conducts a formal review of the condition and performance of participating FIs, including a review of their audited financial statements, to determine their continued compliance with eligibility criteria. The findings of this review are to be recorded in supervision reports.

6.4 ASSESSING PERFORMANCE

Introduction

6.4.1 A wide range of indicators are available for reporting by FIs. The most important are described in this section. Macroprudential indicators—defined broadly as indicators of the health and stability of the financial system—that can help countries assess their banking systems' vulnerability to crisis are discussed in section 7.20.32 of the Knowledge Management Chapter of these Guidelines. Section 6.7 of this Chapter examines the case of Microfinance Institutions (MFIs). The ratios and indicators that are described in other parts of these Guidelines are generally not appropriate for assessing FI performance.

6.4.2 It is important that financial analysts (investment officer) recommend indicators that the FI fully understands and is willing to use in their day-to-day management processes. If an FI is reluctant to prepare and use indicators effectively, or does not have a financial management system capable of preparing the indicators that Bank staff recommends it should be recorded in an Aide Memoire and reported to senior management.

6.4.3 The most important criteria for determining the appropriateness of an FI to act as a financial intermediary are its solvency, profitability, and liquidity. In this respect, since
1988, the Basel Committee on Banking Supervision (BCBS) of the Bank of International Settlements (BIS) has recommended using the CAMELS framework, which looks at six major aspects of a financial institution: capital adequacy, asset quality, management soundness, earnings, liquidity, and sensitivity to market risk.

### Applying the CAMELS Framework

6.4.4 This section describes the application of the CAMELS framework and the benchmarks\(^2\) for each of its components. It is important to note that the CAMELS rating system is subjective and, therefore, should not eliminate consideration of other pertinent factors. Its benchmarks, however, present essential foundations upon which its composite rating is based.

### Capital Adequacy Ratio

6.4.5 Capital Adequacy (CAR) is a measure of an FI’s financial strength, in particular its ability to cushion operational and abnormal losses. A FI should have adequate capital to support its risk assets in accordance with the risk-weighted capital ratio framework. It has become recognized that capital adequacy more appropriately relates to asset structure than to the volume of liabilities. This is exemplified by central banks’ efforts internationally to unify the capital requirements of commercial banks and to generate worldwide classification formulae such as the one proposed here. This indicator requires that assets be classified by reference to their demands on the equity (or capital) structure of the FI.

6.4.6 Capital adequacy comprise of the following components:

- Size of the bank
- Volume of inferior quality assets
- Bank’s growth experience, plans and prospects
- Quality of capital
- Retained earnings
- Access to capital markets
- Non-ledger assets and sound values not shown on books (real property at nominal values, charge-offs with firm recovery values, tax adjustments)

6.4.7 The CAR indicator is derived by comparing the ratio of an entity’s equity to its assets-at-risk. The covenant specifies that the borrower/EA/FI should not make an advance to a sub-borrower if after making the advance; the ratio (the performance indicator) of its equity to its assets-at-risk would be greater than that specified in the covenant.

6.4.8 The BCBS of the BIS recommends a mandatory minimum Capital Adequacy Ratio (CAR) of 8 percent for banks in OECD countries. However, the emerging banking regulatory and supervision system in most of the Bank’s RMCs, combined with an emphasis on directed lending, results in poor portfolio quality. It is, therefore, common

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for RMCs banking regulatory authorities to mandate higher minimum CAR than the 8 percent that BIS recommends for banks in OECD countries.

Assessing Asset Quality

6.4.9 Asset Quality has a direct impact on the financial performance of an FI. The quality of assets particularly, loan assets and investments, would depend largely on the risk management system of the institution. The value of loan assets would depend on the realizable value of the collateral while investment assets would depend on their market value.

6.4.10 The components of asset quality are:
- Volume of classifications
- Special mention loans – ratios and trends
- Level, trend and comparison of non-accrual and renegotiated loans
- Volume of concentrations
- Volume and character of insider transactions

Assessing Management Quality

6.4.11 The performance of the other CAMELS components will depend on the vision, capability, agility, professionalism, integrity and competence of the FI’s management. As sound management is crucial for the success of any institution, management quality is generally accorded greater weighting in the assessment of the overall CAMELS composite rating. Components of the management factors are:
- Technical competence, leadership etc of middle and senior management
- Compliance with banking laws and regulations
- Adequacy and compliance with internal policies
- Tendencies towards self-dealing
- Ability to plan and respond to changing circumstances
- Demonstrated willingness to serve the legitimate credit needs of the community
- Adequacy of directors
- Existence and adequacy of qualified staff and programmes

Assessing Earning Performance

6.4.12 The quality and trend of earnings of an institution depend largely on how well the management manages the assets and liabilities of the institution. A FI must earn reasonable profit to support asset growth, build up adequate reserves and enhance shareholders’ value. Good earnings performance would inspire the confidence of depositors, investors, creditors, and the public at large. The components of earnings performance include:
- Return on assets compared to peer group averages and bank’s own trends
- Material components and income and expenses – compare to peers and bank’s own trends
- Adequacy of provisions for loan losses
- Quality of earnings
- Dividend payout ratio in relation to the adequacy of bank capital
Assessing Liquidity

6.4.13 A FI must always be sufficiently liquid to meet depositors’ and creditors’ demands in order to maintain public confidence. There needs to be an effective asset and liability management system to minimize maturity mismatches between assets and liabilities and to optimise returns. As liquidity has an inverse relationship with profitability, a FI must strike a balance between liquidity and profitability.

6.4.14 Current and quick ratios are inappropriate for measuring FI liquidity. A loan-to-deposit ratio is more relevant. However, an FI’s liquidity and solvency are directly affected by portfolio quality. Consequently, Financial Analysts (investment officers) should carefully analyse the FI’s portfolio quality on the basis of collectability and loan-loss provisioning. Key liquidity components include:
- Adequacy of liquidity sources compared to present and future needs
- Availability of assets readily convertible to cash without undue loss
- Access to money markets
- Level of diversification of funding sources (on- and off-balance sheet)
- Degree of reliance on short-term volatile sources of funds
- Trend and stability of deposits
- Ability to securitise and sell certain pools of assets
- Management competence to identify, measure, monitor and control liquidity position

Sensitivity to Market Risk

6.4.15 Sensitivity to market risk relates the degree to which changes in foreign exchange rates, commodity prices, interest rates, or equity prices can negatively impact the earning power or economic capital of a financial institution. When analysing this factor, particular emphasis should be given to: management’s ability to identify, measure, monitor and control market risk; the institution's size; the nature and complexity of its activities and the adequacy of its capital in relation to its level of market risk exposure. The components of the sensitivity to market risk are:
- Sensitivity of the financial institution’s net earnings or the economic value of its capital to changes in interest rates under various scenarios and stress environments
- Volume, composition and volatility of any foreign exchange or other trading positions taken by the financial institution
- Actual or potential volatility of earnings or capital because of any changes in market valuation of trading portfolios or financial instruments
- Ability of management to identify, measure, monitor and control interest rate risk as well as price and foreign exchange risk where applicable and material to an institution

Assessing FI Risks

Introduction to FI Risk Management

6.4.16 The main concern for FIs is risk management. World capital markets are dynamic, their activities can generate rapid and dangerous movements that need to be anticipated and managed. The ability of traditional performance measurement criteria to indicate declining or poor FI performance is limited. Therefore the capital markets and their regulators and advisers [e.g., the Basle Committee on Banking Supervision (BCBS) and
the International Organization of Securities Commissions (IOSCO)] have developed additional means of measuring performance and, more importantly, to identify problems in a timely manner.

6.4.17 In many cases, the FIs that the Bank deals with are attached to the public sector and have multiple objectives (e.g., sectoral development objectives in addition to profitability objectives). The risk factors associated with these FIs are likely to be more significant than for single-objective commercial banks. Consequently, it is essential that the financial analyst (investment officer) seeks to: (i) identify the principal potential risks that an FI is exposed to; and (ii) develop an appropriate set of indicators that will provide FI management and the Bank with an early warning of problems.

6.4.18 The major risks to be examined include: (i) market risk; (ii) exchange risk; (iii) maturity risk; and (iv) contagion risk.

**Market Risk and Value-at-Risk (VaR)**

6.4.19 Market risk arises from the potential that a borrower or counter-party will fail to perform on an obligation. The assessment of market risk involves evaluating both the probability of default by the counter-party, obligor or issuer and the exposure or financial impact in the event of default. The BCBS of the BIS [www.bis.org](http://www.bis.org) makes recommendations on means to sustain the credit-worthiness of FIs.

6.4.20 The concept of Value-at-Risk (VaR) is very important in risk management. VaR is a measure of the maximum potential change in an FI’s portfolio’s value with a given probability over a pre-specified horizon. In simple terms, the Value-at-Risk is meant to answer the question: “Over a 10-day period, what is the dollar amount of $V$ such that there is only a 1% chance our portfolio will lose more than $V$?” The main advantages of VaR-based management are that: (i) it incorporates the mark-to-market approach uniformly; and (ii) it relies on a short forecast horizon of market variables. Where FI lending is government guaranteed, financial analysts should treat such government-guaranteed bank lending as risk free when estimating VaR.

**Foreign Exchange Risk**

6.4.21 The Bank of International Settlements (BIS) document on Managing Settlement Risk is included in the Knowledge Management Section 7.21 of these Guidelines. The document provides advice and guidance on managing foreign exchange settlement risks. It also defines foreign exchange settlement risk, advises on management practices, and includes guidance on internal auditing.

**Maturity Risk**

6.4.22 Maturity risk relates to mismatching of investments and borrowing operations. To the extent possible, to avoid losses, an FI should seek to match the maturities of subloans and borrowing operations to minimize the risk of having to meet large outgoing interest payments on borrowings and deposits with lower levels of interest receipts from subloans.

6.4.23 Mismatching can be expensive during times of increasing market rates, particularly when the FI may have subloans extended over four to six years with no break or adjustment.
clauses to address rising interest costs. A FI should maintain a running risk analysis of forecast forward transactions with alternative scenarios of market (borrowing rates) to identify the date(s) when it is most at risk, based on its current portfolio. Forecasts of future portfolios can be similarly risk assessed.

Contagion Risk

6.4.24 Contagion can arise in regions, in countries, in regions within countries, or within a class or category of financial intermediaries (such as agricultural FIs). Contagion risk can arise where declining economic conditions for depositors and sub-borrowers simultaneously cause a shortage of funds and a rapid increase in defaults on subloans. This condition can automatically trigger a substantial rise in the risk premium of major lenders that prevents an FI from covering shortfalls.

6.4.25 Anticipating and avoiding contagion risk is best addressed by financial sector supervisors and regulators because they should maintain a consistent, regular overarching view of the financial sectors and of the local/national/international economies with the objective of providing early warnings, not only to the financial intermediary, but to the appropriate ministries that are charged with economic management.

The Role of Regulators in Risk Management

6.4.26 The financial analyst (investment officer) should interview regulators and receive assurances that the following matters are addressed:
- Market surveillance for large positions
- Cross-market supervision
- Setting of capital reserves
- Disclosure of data on market value of financial instruments and risk policies to achieve least-cost uniformity in the sector
- Examination of FIs’ records and internal controls
- Optimum collaboration with FIs’ auditors
- International, regional, and national linkages and exchanges of information
- There is a set of rules and requirements that, at the lowest possible cost, effectively contributes to prevent an isolated failure or crisis of small proportions threatening the market as a whole
- To the extent possible obtaining voluntary convergence and agreement on the role of the regulator
- A complete set of emergency plans
- That the emergency plans are constantly updated
- That the emergency plans are agreed between the central bank and FIs

Other Key Risk Management Steps

6.4.27 The following steps should be considered as means of supporting the generation of useful and accurate performance indicators in an FI: (i) the use of a consistent set of accounting standards (IOSCO supports the use of IASs); (ii) efficient netting agreements; (iii) segregation of customers’ accounts and protection of customers’ funds in event of bankruptcy; and (iv) ensuring regulators are kept fully informed, and are efficient in their reporting.
Determining FI Credit Ratings

6.4.28 The BCBS of the BIS released, in April 2003, an overview paper to accompany its Third Consultative Paper (CP3) on the New Basel Capital Accord (also known as Basel II). The CP3 that can be accessed at: <www.bis.org/bcbs/cp3ov.pdf> represented an important step in putting the new capital adequacy framework in place. The BCBS finalized the New Accord - Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework - in June 2004 with implementation to take effect in G-10 countries by year-end 2006. This statement by the BCBS, agreed by all its members, details the agreed Framework for measuring capital adequacy and the minimum standard to be achieved. The Revised framework can be accessed at: <www.bis.org/publ/bcbs107.pdf>. The BIS does not envisage implementation of the new accord in non-G-10 countries by the end of 2006. Staff processing loans, including FILs or Technical Assistance involving the banking sector should be aware of the views of the national banking supervision authorities in the applicable country regarding the implementation of the New Accord and/or changes contemplated in their supervision framework that currently do or plan to incorporate some or all of the recommendations contained in the New Accord. The views of the national banking supervision authorities should be disclosed in the Appraisal Report.

6.4.29 Financial analysts (investment officers) are required to determine the credit rating of the FI being appraised. In some cases, these credit ratings will be readily available from published sources (for instance, the Standard & Poor’s Global Ratings Handbook). In other cases, the financial analyst (investment officer) can determine the FI’s credit rating by questioning other FI’s in the country or region.

Specialized FI Internal Controls

6.4.30 Internal controls for FIs are employed by banks and securities institutions and should: (i) comprise a set of rules and procedures designed to provide qualitative standards that are complimentary to the quantitative analysis of risk; (ii) be used to internally manage operational risk, agency risk, and legal risk; and (iii) be exercised by an independent control unit reporting to the Board, and having no operating linkage with trading activities that create risk. Their objective is to enhance the risk management culture in the organization, including by:

- Requiring transparency of reports and documentation of the risk control process
- Monitoring the content and the efficiency of the vertical and horizontal information flows
- Monitoring and reporting on accountability
- Ensuring remuneration policy rewards efficient risk management through high returns and minimum risk
- Monitoring observance of trading limits and market procedures
- Establishing rules for dealing with changes in volatilities
- Testing the soundness of models
- Examining the quality and uniformity of data input
- Validating and back-testing procedures

3 G-10 is comprised of eleven countries with the largest banking institutions including Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.
6.5 APPRAISAL CHECKLIST

6.5.1 A checklist for appraising an FI project is provided in the Knowledge Management section (see section 7.16). However, the generic appraisal checklist should be used with caution and appropriately modified to address the nature and form of the FI being appraised because FIs: comprise a wide range of institutions, including Apex institutions that service one or more FIs in a country; may provide services to one or more sectors in a country (agriculture, various categories of industry, etc.), including support to microfinance organizations.

6.6 REPORTING AND AUDITING ISSUES

Introduction

6.6.1 Financial reporting by, and audits of, FIs require individual specifications for each institution so that financial reporting and auditing requirements will be appropriate to the type, nature, and form of the institution. For example, an industrial FI and a microfinance FI have few common characteristics and the reporting requirements and the auditing specifications will differ sharply.

6.6.2 Unless the financial analyst concerned is well-experienced in the financial management of FIs, it is recommended that a consultant be employed, who is experienced with the type of FI that is to be the subject of financial reporting, and later, auditing. Specific guidance on MFI reporting and auditing issues is given below.

FI Financial Reporting

6.6.3 FIs should be required to report in accordance with IAS No. 30 (Disclosures in the Financial Statements of Banks and Similar Financial Institutions). In addition to the standard statements (Balance Sheet, Income Statement and Cash Flow Statement), an FI should be required to provide the additional statements listed below. This listing is not all-inclusive and should be amended to address the objectives and operations of the FI to be audited:

- The income statement and balance sheet adjusted for subsidies
- Portfolio Report for current and two past years
- Portfolio Report showing aging of receivables (arrears)
- Portfolio Report showing aging of portfolio at risk
- Capital Adequacy Analysis
- Assets Structure by Income
- Table of Contingencies, Guarantees, Commitments showing corresponding securities and collateral

FI Auditing

6.6.4 Selection of an auditor for a FI should include the provision of a TOR that is specifically geared to the FI concerned. In addition to the standard requirements (see Chapter 5) for auditor selection and appointment, including providing a report and an opinion on the annual financial statements, the auditor should be required to include in the report confirmation, or otherwise, that the additional financial statements and the performance indicators listed above can be relied upon.
6.6.5 The FIs Terms of Reference should also address the following:

- The auditor’s impression of the efficiency and effectiveness of the overall operations and condition of the institution
- The adequacy of the intermediary’s risk management systems and internal control procedures, including whether or not the bank uses VaR, and if so whether its use is professionally managed under a separate non-lending manager; results achieved during the fiscal year; and the operation of VaR as at the date of completion of the audit
- The quality of the loan portfolio and adequacy of loan loss provisions, illustrated as necessary by use of performance indicators above
- The competence and effectiveness of management, including development of strategic plans and their implementation
- The adequacy of accounting, financial reporting and management information systems
- The adequacy of public information systems
- The resolution, or otherwise, of issues identified off-site or during previous on-site supervisory processes
- Adherence to laws and regulations and terms of licenses and agreements, including loan covenants with the Bank
- A commentary on central bank or other forms of regulatory supervision during the fiscal year
- Quality of human resources employed by the FI and their potential to efficiently sustain all areas of the FI’s operations

6.7 MICROFINANCE INSTITUTIONS

Bank Experience

6.7.1 In 1999, the Bank established the ADF Microfinance Initiative for Africa (AMINA), to bring microfinance to its operations. Through AMINA, the Bank Group was able to contribute to building the capacity of microfinance institutions (MFIs), expanding the outreach of 70 MFIs in ten countries to hundreds of thousands of additional clients. By the time of its closure in 2002, the implementation of the AMINA initiative had generated a number of lessons, the most important of which led to the current microfinance mainstreaming within the Bank.

6.7.2 In 2004, the Bank adopted the Eleven Principles of Microfinance which were sanctioned by the G8 Summit. To this regard, a “Microfinance: Policy and Strategy for the Bank Group, January 2006” has been issued and work has commenced to prepare detailed guidelines to operationalize the Policy and Strategy. Importantly, the document outlines the policy and strategy of the Bank in microfinance, which is to support the RMCs to build sustainable systems of financial intermediation and mainstream them into their formal financial sectors. It, also, outlines four specific strategic areas of orientation and intervention for the Bank’s work in microfinance:

- enhancing key stakeholder capacity in microfinance, including financing the expansion of microfinance institutions (MFIs);
- creating an enabling environment that promotes the building of inclusive financial systems that serve the poor;
- enhancing strategic partnerships; and
• facilitating knowledge management to ensure effective research, information collection, and dissemination.

6.7.3 Another useful Bank document is the “Operational Guidelines for the Rural Financial Sub-sector, October 2002”. This guideline aims to provide a detailed tool to the Bank microfinance designers on how to formulate microfinance projects, design financial products, establish management information systems, set up accounting systems, identify risks and measure performance of microfinance interventions.

International Bodies

6.7.4 The Consultative Group to Assist the Poorest (CGAP) publishes specific guidance on Microfinance Institutions (MFI) reporting and auditing issues. This guidance includes Handbooks for MFI auditors, Guidelines for MFI financial statements, and a handbook on appraising an MFI. These materials can be accessed online at www.cgap.org.

6.7.5 The World Council of Credit Unions (WOCCU) recommends a set of financial ratios covering Protection, Effective financial structure, Asset quality, Rates of return and costs, and Liquidity and Signs of growth (PEARLS) to monitor the financial stability of Credit Unions, including MFIs. The PEARLS methodology is specifically designed for evaluating credit unions and addresses shortcomings of the CAMELS system in this respect. Further information on the PEARLS methodology can be found in the Knowledge Management section 7.22 of these Guidelines and at www.woccu.org.