COMMONWEALTH
OF THE BAHAMAS

THE BAHAMAS -

GOVERNMENT LENDING POLICY FRAMEWORK

- DEBT MANAGEMENT OFFICE, MINISTRY OF FINANCE -

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Abbreviations

DMC	Debt Management Committee
DMO	Debt Management Office
DSA	Debt Sustainability Analysis
GBE	Government Business Enterprise
GOB	Government of The Bahamas
IMF	International Monetary Fund
MDA	Ministries, Departments and Agencies
MOF	Ministry of Finance
PDMA	Public Debt Management Act
PFMA	Public Finance Management Act

Definitions

Agency	An entity of the government that is not a Ministry or a Department and is not a Government Business Enterprise and is listed in the Fourth Schedule of the Public Finance Management Act, 2023 (the PFMA).
Credit Risk	The risk that a borrower may fail to repay a loan, resulting in the lender potentially losing either the loan's principal, the associated interest, or both.
Government Business Enterprise (GBE)	An entity owned or controlled by the government that provides services in the market or undertakes commercial activities and are listed in the Fifth Schedule of the PFMA.
Loan Agreement	Formal documentation of the loan arrangement.
On lending	The process where government borrows funds by way of a principal loan agreement (the “PLA”) from a foreign government for international agency and on-lends these via a subsidiary loan agreement (the “SLA”)to an in-scope entity. The PLA is executed by the Minister of Finance on behalf of the government as borrower, and the SLA is executed between the government and the in-scope entity as implementing agency upon terms and conditions agreed with the government

Section 1: Introduction

1.1. Purpose

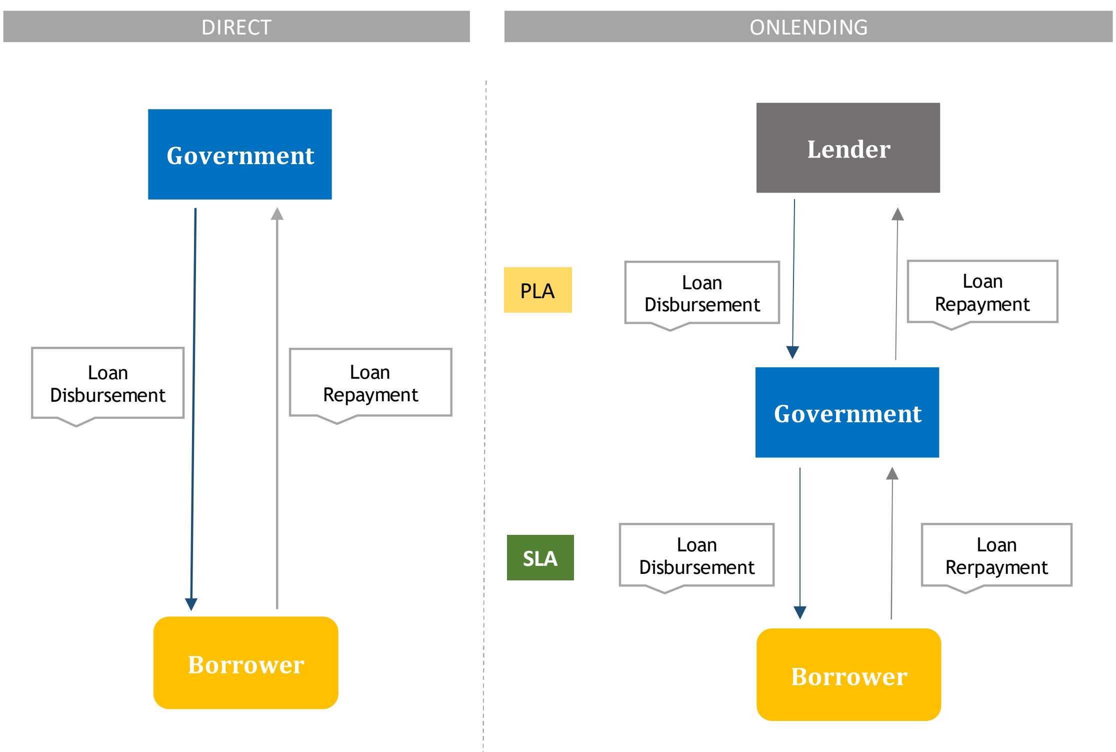
Over the years, the government has provided loans to state-owned and private sector entities, to enable the achievement of key development goals, at reasonable costs and risks. Failure on the part of these entities to honour these obligations can create significant fiscal and reputation risk to the government's operations.

In keeping with the requirements under section 37 of the Public Debt Management Act, 2021 ("the PDMA"), the Government Lending Policy Framework (the "GL Policy Framework") provides coherent guidelines to govern arrangements for the provision of direct loans and on-lending to in-scope entities. By managing the fiscal risks associated with these lending activities, the GL Policy Framework supports the government's achievement of fiscal resilience and public debt sustainability over the long-term.[1]

The GL Policy Framework does not cover guidelines on whether loans provided to the government should be on-lent to in-scoped entities. However, where this decision is taken by the Cabinet, the GL Policy Framework provides evaluation and decision making guidance for these activities.

The GL Policy Framework is to be read in conjunction with the relevant governing legislation cited in 2.1.

Figure 1: Typical Lending Flow Diagram



[1] This document was drafted under the Commonwealth Secretariat's debt reform project entitled, 'Strengthening Public Debt Management Framework and Developing Government Bond Market in The Bahamas,' with the funding support of the India UN Partnership Development Fund and the Government of The Bahamas.

1.2. Definition of Lending

Government lending activities could take the form of direct loans and on-lending—both of which pose a threat of credit risk in terms of the borrower's ability to repay.

- **Direct lending** is defined as a process where the government lends its own resources to Agencies and GBEs, with terms and conditions stipulated in the loan agreement. Also included are government-guaranteed loans to all in-scope entities that were invoked and subsequently converted by the government into new loans to these entities.
- **On-lending** involves a process where the government borrows funds (normally from a foreign government or an international agency) under a principal loan agreement (the "PLA") and lends it to a government business enterprise ("GBE"), Agency or any other entity that is legally entitled to borrow from the government, with terms and conditions stipulated in the subsidiary loan agreement (the "SLA").

1.3. Policy Objectives

The principal objectives of the GL Policy Framework are to:

- give operational effect to the legal provisions contained in section 37 of the PDMA relating to lending by the government;
- provide operational clarity to all in-scoped entities involved in government lending activities;
- ensure judicious evaluation, monitoring and management of fiscal costs and risks associated with government lending;
- uphold the key principles of transparency and accountability in government decision making; and
- support effective and efficient use and management of public resources.

1.4. Scope

The scope of the GL Policy Framework is to provide evaluation and decision-making guidance for prospective loan beneficiaries, the Debt Management Office (the "DMO") and the Ministry of Finance (the "MOF") with respect to requests for government loans.

In accordance with the PDMA, the GL Policy Framework shall apply to loans to Agencies and Government Business Enterprises (GBEs)—as defined in the Public Finance Management Act, 2023 ("the PFMA"), and private domestic companies and foreign entities—the latter two categories on an exceptional basis, only.

<u>Exclusions</u> to the GL Policy Framework are:

- ***Loans for the benefit of private individuals***—covering educational loans, housing loans, and loans to small- and medium-sized enterprises. The government will rely on the accountability, transparency and risk assessment mechanisms within existing loan programmes governing these activities to assess the creditworthiness of individuals and ensure prudent use of public resources.
- ***Loans for Foreign Governments***—These will be made upon the recommendation of the Cabinet to Parliament, and supported by input from the Ministry of Finance.
- ***Loans for Public Private Partnerships (PPPs)***—which are issued as part of a risk sharing arrangement with the objective of improving the viability and sustainability of a project, will be addressed within the context of the government's PPP policy.

1.5. Administration and Review

The DMO is to:

- administer the GL Policy Framework
- maintain a comprehensive database to record, manage, monitor and report on all government lending and related activities, in accordance with the requirements of the PDMA and the PFMA.
- review the GL Policy Framework, at least every five years, to ensure ongoing relevance and alignment with applicable standards and legislation, ad experience gained in implementing the framework.

Any amendments recommended by the Director, DMO (the "Director"), after consultation with the Debt Management Committee (the "DMC"), are to be provided to the Minister of Finance (the "Minister") for Cabinet's approval. Thereafter, the amended GL Policy Framework is to be published before coming into effect.

Section 2: Legal and Institutional Framework

2.1. Legal Framework

The GL Policy Framework forms a part of the government's broader debt management arrangements and is anchored in a sound legal architecture based on the following:

- Public Debt Management Act, 2021.
- Public Financial Management Act, 2023.

2.2. Reason for Issuance of Loans

As outlined in the section 38 of the PFMA, the Minister must be satisfied that it is necessary or expedient in the public interest to lend money.

Government loans will normally be extended for the purpose of achieving the following objectives:

- In the case of direct loans, to provide short-term liquidity support to a GBE or Agency for a period of up to one (1) year.
- To support implementation of development projects by in-scope entities, thereby allowing access to medium- to long-term financing options at the lower cost.
- A new loan offered as a recourse action to a guarantee that has been invoked.
- For a foreign government, the loan mist be for the purpose of assisting the economic development of that country and for the welfare of its citizens (see section 39 of the PDMA).

2.3. Eligibility Criteria

The Minister will only consider applications for loans where the request meets one or more of the following principles:

- The GBE or Agency has a short-term liquidity requirement that cannot be met from market sources.
- The project contributes positively to the development priorities of the government, and has positive economic returns.
- The entity seeking government lending must submit an application along with the required documentation, as outlined in this document, and adhere to the due process specified herein.

Direct Loans to Agencies/GBEs are intended to be of a short-term nature and, while not subject to the rigorous credit risk assessment process, must be based upon the capacity of the borrower to honor these obligations.

On lending proposals, which are linked to an investment project, must undergo a rigorous credit risk assessment and score an acceptable rating (i.e., low to medium). Where this is not the case, the government will reserve the right to determine whether to approve or deny, based on the project's ability to generate positive financial and economic benefits to the country as determined within the credit risk assessment exercise.

2.3.1. Other Entity Specific Eligibility Requirements

a. Agencies/GBEs:

- Be compliant with all provision of the PFMA—including reporting requirements.
- Have no National Insurance Board (NIB) contribution arrears.
- Have no other tax or debt arrears.

  In cases where there are arrears, the request may be considered if the underlying project will produce positive financial returns and confer economic and social benefits to the country. Arrangements must also be in place to settle the arrears.

b. Private domestic companies:

- Have no debt arrears.
- Have no NIB or government tax arrears or, where they exist, formal arrangements are in place to settle.

c. Foreign companies

- Projects for consideration will be those that are expected to deliver a net economic return to The Bahamas and would not otherwise be developed by an Agency/GBE or domestic private company.
- Projects that have commercial characteristics and can generate income by charging market prices to compensate for costs will not be considered.
- Have no formal debt arrears.
- Have no tax arrears.
- Have no NIB contribution arrears.

2.4. Governance and Institutional Framework

The governance and institutional arrangements for lending will typically involve one of more of the following institutions.

- Parliament
- Cabinet
- Ministry of Finance (MOF)—the Minister and the Financial Secretary
- Debt Management Office (DMO)
- Debt Management Committee (DMC)
- Office of the Attorney General(OAG)
- Ministries, Department and Agencies (MDAs)
- Agencies and GBEs
- Other

2.4.1. Roles and Responsibilities

a. Parliament (House of Assembly)

Approve resolutions for all on-lending arrangements entered into on behalf of or in the name of the government with foreign governments.

b. Cabinet

Approve, on behalf of the Executive, the policy framework for the granting of government direct and on-lent loans.

c. Debt Management Office (DMO)

Under Section 7 the PDMA, the DMO is to:

- maintain timely and comprehensive records and database of all loans—recording loan disbursements, payments.
- use the loan database to generate invoices for billing entities of payments coming due under the lending arrangements
- assess the risks in issuing any lending; prepare reports on the method used for each assessment and submit the results to the Financial Secretary for transmission to the Minister.
- facilitate the recovery of any payments, including interest and other costs incurred by Government, due to the honouring of lending activities.
- prepare annual reports on outstanding lending by the government.
- submit to the DMC for review proposals for issuance of loans.

d. Director, DMO

Under section 37 of the PDMA, the Director is to:

- prepare/amend the policy framework for lending by government in consultation with the DMC and publish the policy framework after approval by Cabinet.

e. Debt Management Committee (DMC)

Under Section 8, the DMC is to:

- assist and advise the Minister on matters relating to the grant of loans by the government.
- provide overall guidance to the DMO on lending by the government.
- review proposals for issuance of loans by the government, and other proposals as may be submitted to it by the DMO for consideration or for obtaining the approval of the Minister.

f. Ministry of Finance

The Minister has the power to issue loans and is required to table in Parliament reports relative to these loans.

The Financial Secretary is to:

- review the risk assessment reports on issues of lending operations of the government submitted to the Minister by the DMO.
- oversee the domestic public debt, external public debt, including lending, consistent with the fiscal strategy report and the annual budget.
- monitor aggregate limits on lending, consistent with, the fiscal strategy report and the fiscal policy approved within the annual budget process.
- ensure that the annual budget includes plans for lending to public or private entities; along with annexes denoting any limits for issuing these loans.

g. Treasurer

Under the PFMA, the Accountant General is to:

- prepare, sign and transmit to the Auditor-General to audit a statement of loans issued by the government.

h. Office of the Attorney General

Assist with the drafting all draft loan documents.

i. Parent/Responsible Ministries/Departments

- Conduct initial reviews of all loan applications from Agencies and GBE, as applicable.
- Assist with the overall monitoring and reporting requirements for loans.

j. Treasurer

Under the PFMA, the Treasurer is to, inter alia,:

- oversee the disbursement of public funds.
- report on the financial position of the government.

k. Technical Committee (TC)

A technical team, led by the Director, will be appointed to carry out credit risk assessments—and is to be constituted as follows:

- Director,
- Debt Officer/Analyst (Policy and Risk Management Section, DMO)
- Staff from Treasury Department
- Parent/Responsible Ministry or Department staff
- Consultant, as deemed necessary

The TC will meet as and when necessary to carry out credit risk assessments for loans to eligible entities. The TC will also meet half-yearly to discuss the management status of loans, loan performance and reporting.

Section 3: Lending Risk Mitigation Measures and Considerations

3.1. Loan Limits

In keeping with prudential norms, the government will impose the following limits on lending transactions.

- The optimal stock of government loans shall be a percentage of nominal gross domestic product, as determined by the Fiscal Strategy Framework and debt sustainability considerations.
- The maximum limit for loans, as a percentage of the total loan amount that could be extended to any public entity at each point in time, shall be based on the entity's creditworthiness.
- For a new company/private sector firm or GBE which has no historical reference, the financial and economic viability of the investment will be used to assess the company.

3.2. Loan Conditions

The government may impose certain conditions on the grant of a loan—to include, ***inter alia***:

- The posting of collateral—in the case of non-public sector entities and public sector entities having less than 100% ownership by the government.
- Restricting the use of loan proceeds to the investment project only.
- Submission of regular reporting on the investment project, along with audited financials and ad hoc financial reports.
- Restrictions on future borrowings—depending on the outcome of the credit risk assessment exercise.
- Execution of a formal loan agreement, with terms and conditions to be agreed with the government.
- The government's borrowings from the primary lenders are expected to be on semi-concessional terms. Where possible, the terms and grace period for the on-lending will be the same as under the PLA. In special situations, with the approval of the Minister, and upon the recommendation of the DMC after its assessment, the tenor for the on-lending arrangement and interest charged (a risk margin based on credit worthiness of the borrowing entity and other factors added to the original rate) may differ.
- Repayments to be made in domestic currency or foreign currency equivalencies to match debt servicing obligations.
- For *Direct Loans*, the interest rate to be charged will be based on the domestic commercial banks' Prime Rate, plus a margin—depending on the outcome of any risk assessment exercise.

3.3. Collateral

Where applicable, the acceptable collateral for a loan to a non-public sector entity will include cash; stocks and negotiable bonds; irrevocable letters of credit; certificates of deposit; assignment of receivables (e.g. export earnings, electricity generation charges, road tolls, and telecom receipts); and physical assets such as buildings, ports, and industrial plants.

In accordance with section 41 of the PDMA, collaterals are to be in the name of the Treasurer.

The Minister will exercise powers to realize the collateral in accordance with the terms of the loan agreement executed with the borrower.

3.4. Preparation of the Loan Agreement

Following Cabinet's approval, the DMO will provide the Office of the Attorney General (the "OAG") with the necessary documents/details to review the proposed terms and conditions of the on lending facility as drafted by the lender and to prepare the corresponding SLA, and to draft a loan agreement in respect of a direct loan facility.

The SLA/direct loan agreement will be signed between the Borrower and the Minister, and should, *inter alia*:

- follow a standard format. As prepared by the OAG.
- outline the responsibilities of all parties (i.e., the government and the Borrower) and the terms and conditions.
- specify all reporting requirements of the Borrower.
- be issued for the period of the loan.
- include any conditions and criteria the government, at its discretion, deems appropriate.

3.5. Parliamentary and other Requirements for Loans

Lending to a government of a foreign country is to receive the affirmative resolution of both Houses of Parliament, as specified in section 39 of the PDMA.

All lending activities must be reported in the financial statements of the government, as specified in section 40 of the PDMA.

Section 4: Guidelines for Government Lending

4.1. Introduction

The need for a government loan by in-scope borrowers could be identified during multilateral country assistance strategy meetings, or during financing discussions with the Ministry of Finance.

- All requests for government <u>short–term liquidity support loans</u> to GBEs and Agencies will be subject to an internal review by the Ministry of Finance, and may not necessarily undergo a rigorous risk assessment review.
- All requests for <u>on-lending</u> by the government with be subject to the government's credit risk assessment. To align this evaluation process as closely as possible to the annual budget process, and to allow for early input from the MOF, in-scope entities are expected to submit their requests during the time of the annual ***Budget Call Circular*** exercise, which usually commences in February each year. However, the government recognizes that there may be exceptions to this timeframe, in which case these requests will be considered on this basis—subject to conformance with the overall loan limit.

4.2. Lending Application Procedures

a. Direct Loans

Applications from Agencies and GBEs for short-term liquidity support must be submitted through the Parent/Responsible Ministry or Department, who are expected to ensure that it outlines, in detail the nature of the request and how the entity expects to repay the loan on time.

b. On Lending

All applications for government on lending should be submitted to the MOF to the attention of the Financial Secretary.

- Applications from Agencies and GBEs must be submitted through the Parent/Responsible Ministry or Department, who are expected to confirm, before forwarding to the MOF, whether:
  - the loan requested satisfies national priorities—in keeping with the objectives outlined in sections 2.3 and 2.4, above.
  - all other potential funding opportunities were well examined.
  - the prospective loan is within the government's overall loan limit.
  - terms and conditions of the loan appear satisfactory and in accordance with the borrower's legislative framework.

4.2.1. Documentation Requirements

An application shall be deemed to have been made successfully only where the following documents/information have been completed and submitted in accordance with the GL Policy Framework.

- Term sheet from the lending institution (specifying loan amount, currency, interest rate, maturity, grace period, other fees and conditions) of the amount to be lent, draft loan agreement).

- All documents and details related to the proposed investment project to be financed—to include the business case (i.e., project outline, economic and financial impact, cash flow projections, scenario analysis and assumptions, project management and monitoring plans).
- Where applicable, board resolution clearly stating the board's decision and reasons for applying for a loan, and the intended use of the Loan, and agreement to comply with the GL Policy Framework.
- Information on how risks affecting the loan repayments would be monitored and mitigated throughout the life of the loan, including the role of the parent ministry.
- Details of all existing loans, overdrafts or any other financial exposure, and the security that has been offered for those commitments.
- Annual Reports and audited financial statements for the past three years, and the pro forma financial statements showing forecasted figures are for the current year and the next two years.
- Copy of business license, as applicable.
- A statement of money owed to the government, where applicable.
- Stand-alone credit rating, where applicable.
- Updated financial forecasts of the borrower for the duration of the proposed loan—to include scenario analysis and assumptions.

The DMO reserves the right to request additional information and, where deemed necessary, the applicant will be required to make a formal presentation to the TC.

4.3. Loan Evaluation and Credit Risk Assessment

The Financial Secretary, on behalf of the Minister, will forward the application to the Director for appropriate assessment and its recommendation on whether to offer a loan.

4.3.1. Specific Activities

a. DMO

- Ensures the completeness of the application and, where this is not the case, request any missing information from the submitting entity.
- Ensures that the application is compliant with the eligibility requirements and can be offered without breaching the limit established for loans.
- Ensures that the prospective loan is within fiscal sustainability considerations.

b. TC

- Once the application is deemed to be complete, the Director will convene the TC, which may require applicants to make formal presentations of their requests. The TC will, ***inter alia***,:
    - undertake the credit risk assessment for on-lent loan application—based on a credit scoring model (see ***Annex 1***) and produce estimates of the cost and risks of the proposed loan.
    - confirm the reasonableness of the financial forecasts provided by the applicants.
    - determine how the loan would affect the government's portfolio of outstanding debt levels.
    - consider and recommend whether conditions should be attached to the proposed loan.

- Upon completion of its review process, the TC will prepare an assessment report (the Report), to include:
  - a summary of the results of the credit risk assessment; and the probability of default and risk margin to be added to basic interest rate.
  - a recommendation on whether a loan should be offered; where an application is not successful, reasons for the decline and where a positive recommendation is advanced, any conditions to be considered.
  - details of the proposed interest rate for the loan and other charges.
- The TC, via the Director, will submit the Report to the DMC for its consideration.

c. DMC

- Before making a final recommendation to the Minister, the DMC will review the Report of the TC and ensure, ***inter alia,*** that:—
  - the cost-benefit assessment is based on national priorities outlined in the government's economic and development plans.
  - the appropriate business and financial risk profile indicators are selected for carrying out the credit risk assessment.
  - the appropriate weights are used for the credit risk assessment and project feasibility (i.e., economic and financial returns, debt servicing capacity) are acceptable.
  - the proposed loan interest rate (basic rate plus premium for credit risk, currency risk, term of loan) and other up-front charges are appropriately calculated.
  - the request could be considered within the limit established for the overall stock of loans.

4.4. Final Approval of Loan Application

The Minister, after considering the recommendations for a loan made by the DMC, may approve or deny the offer of a loan and impose other conditions or requirements as are considered necessary in the national interest.

The Minister's final decision will be communicated to the DMC, the TC and the DMO, via the Financial Secretary, who will request that the DMO Director prepare a Cabinet Paper (with the Report of the TC as an attachment) to submit the Minister's decision for Cabinet's no objection.

4.5. Notification of Decision(s) to Applicants

Following receipt of Cabinet's no objection, the Financial Secretary will communicate, in writing, the final decision of the Minister on the loan application.

- In the case of an Agency or GBE, decisions will be forwarded directly to the Parent/Responsible Ministry or Department.
- For all other entities, the decision will be forwarded to the requesting entity.

Section 5: Recording Monitoring and Reporting of Lending

5.1. Recording Monitoring and Reporting

All loans are to be recorded and monitored in the government's debt recording and analysis system to ensure that conditions are being met and to manage any potential risk. These responsibilities are to be carried out through the collective activities of the various entities involved in the loan process.

a. DMO/Ministry of Finance

- Record the qualitative descriptions and quantitative information (actual and forecast) of the loan in the Commonwealth Secretariat Meridian ("Meridian") debt recording and analysis programme.
- Ensure that electronic versions of all executed documents are securely stored in Meridian.
- Monitor the progress on the loan transactions in a prompt manner and detect any sign of payment difficulties, well in advance.
- Invoice borrowers for payments of loan interest, principal and fees.
- Record loan disbursements, interest and principal repayments and loan fees.
- Generate half-yearly reports (end-June and end-December) on loans for the Minister to present to Parliament—within three months after the respective periods.
- Publish information on loans as part of the government's quarterly Fiscal Reports.
- In the case of default, the MOF should recommend to the Minister, for Cabinet's final decision, on what recourse action should be taken.

Figure 2: DMO's Responsibilities for Government Lending Management

Portfolio Management

- Receiving applications
- Assessing applications against pre-set criteria
- Presenting applications to the Technical Committee for risk assessment
- Drafting loan letters
- Evaluating loan requests

Policy & Risk Management

- Conduct credit risk assessment for applications
- Conducting credit risk assessments for portfolio of loans
- Estimating loan fees

Debt Operations

- Recording loans
- Monitoring of loan disbursements
- Monitoring of repayments
- Reconciling and sharing of lending data
- Reporting and disclosure

b. Borrowers

- Submit copies of the annual reports and audited financial statements to the DMO during the entire duration of the loan.
- Provide relevant information on the use of funds, disbursements, accounting and degree of implementation of the project funded by the loan, and conduct regular consultations with the DMO.
- Ensure that all loans are reviewed annually, and copies of reviews forwarded to the DMO, via the Parent/Responsible Ministry or Department, as applicable, by July 31.

c. Parent/Responsible Ministry or Department

- Monitor whether the Agency/GBE is discharging repayment/interest obligations as per the terms of the loan agreement, whether the repayment capacity for the loan amount is impaired in any manner and whether all covenants and conditions are being upheld. Copies of these reviews should be forwarded to the DMO annually, by July 31.

Section 6: Event of Default

A default is deemed to occur if the borrower fails to pay in accordance to the payment schedule in the underlying loan agreement executed with the government.

- The borrowing entity should inform the Director of any case of impending default, well in advance, along with corrective measures proposed.
- The Director will conduct a thorough review of the event, utilizing up to date financial condition reports to be supplied by the borrower, in order to make an appropriate recommendation to the Minister on how to proceed.
    - The Minister may consider activating the collateralization process, where applicable, or consider restructuring the terms of the loan to provide the borrower with sufficient time to cure the default.
    - The Minister will report to the Cabinet all events of default, recourse actions and any proposed modifications to the original loan terms.

Section 7: Credit Risk Assessment and Expected Loss

7.1. Credit Risk Assessment

Credit risk assessments help to evaluate how credit worthy is the borrower in terms of repayment of the loan. The selected methodology, termed the `credit scoring model, contains a number of features and steps.

- An assessment is undertaken of the financial and business risk indicators of the beneficiary over the past 3 years and the forecasted figures are for the current year and the next two years
- Financial risk indicators are based on typical financial ratios that represent profitability, liquidity, solvency, debt structure and performance in meeting financial obligations to Government.
- Business risk indicators are categorized under ‘regulatory environment’, ‘sector risk and competitive position’ and, ‘governance and management’.
- Risk range can vary from low risk (1) to `distress’ (5).

7.2. Weighting and Average Weighted Score

- The individual scores assigned to each indicator are multiplied by corresponding weights determined by its priority.
- After obtaining a weighted score for each indicator, an overall average score is estimated.
- Average weighted scores are used in assessing creditworthiness, probability of default and risk margins.

7.3. Probability of Default

- The weighted average scores are converted through the use of sovereign credit rating score assigned by the credit rating agencies.
- Rating agencies usually have a numerical value of probability of default attached to their alphabetic grading structure.

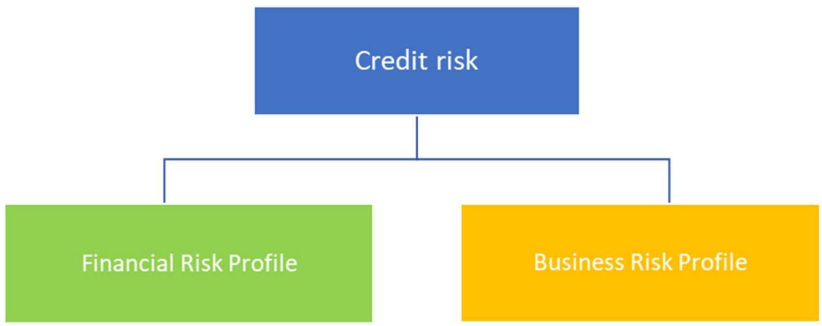
7.4. Expected Loss

- Expected loss estimations are to be jointly carried out by staff of the DMO and the Treasury Department.
- Expected loss estimates may be used for budget provisioning and for estimating contingency reserves, as deemed necessary.

Annex 1: Credit Risk Assessment: A Credit Scoring Approach[2]

1.1 Risk Indicators

On-lent loans to Agencies and GBEs and other approved entities expose the government to credit risk. The credit risk, in turn, depends upon two major underlying factors, viz., the business risk profile and the financial risk profile. The business risk profile factors are generally qualitative while financial risk profile factors are quantifiable.



The credit scoring method is used to assess and quantify credit risk, as it is simple, user-friendly and allows use of both quantitative and qualitative information. The application of this method, however, involves a number of steps, viz,

(i) identify the business and financial risk indicators;

(ii) assign weights to each risk indicator, depending upon the influence of these indicators on determining the level of government's exposure;

(iii) assign scores to each risk indicators, based on the entity's performance; (iv) calculate the weighted score of each risk indicator; and

(iv) sum these weighted scores to obtain the overall risk rating of the entity.

As a starting point, the methodology begins with selected business and financial risk indicators, which would be increased over time, as the assessment process matures. Selection of business and financial risk indicators will depend upon the sector/area of operation of the prospective Borrowing Entity. Availability of data, information, resources, and capacity of the staff to carry out this exercise will also influence application of the model.

1.1.1 Business risk factors

The Business Risk Profile of a Borrowing Entity is to be determined based on the combined assessment of factors, namely, the regulatory environment, sector risk and competitive position, and governance and

[2] The methodology is adopted from `Credit Rating Tool to Assess and Quantify Credit Risk from Public Corporations' Guidance Note, The World Bank, 2022. World Bank acknowledges in its Guidance Note (pages 1,2) that the application of the model should consider the country context in terms of the availability of data and information, resources available and staff capacity to carry out this exercise.

management of the borrowing Entity/GBE provided as provided in **Table 1,** which shows examples of questions to be raised.

Table 1: Business Risk Factors and Assessment Considerations

Categories	Assessment (based on questions/responses)
Regulatory Environment	▪ Is there relevant laws and regulations with regard to the industry and enterprise? ▪ Does the legal environment allow to recover running cost, capital cost and new investment programmes? ▪ Is the legal framework consistent with other laws and regulatory authorities?
Sector Risk and Competitive Position	▪ Is the industry affected by macroeconomic factors? What is the proportional impact for the agency/business enterprise? ▪ What is the competitive position of the enterprise (past and future prospects)? ▪ What is the enterprise's growth prospects?
Governance and Management	▪ Does the governing board act independently and has members who are competent and qualified? ▪ How well does it enforce legal, regulatory and policy reforms? ▪ Does the financial and other reports submitted on time?

Table 2: Typical Financial Risk Indicators

Categories	Specific Variables and Indicators	Definition/Assessment
Liquidity	*Current Ratio*	Current assets to current liabilities
	Quick Ratio	Current assets (excluding inventory) to current liabilities
Profitability	*EBITDA margin*	Earnings before Interest, Taxes, Depreciation and Amortization as a percentage of Revenue
	RoA	Rate of Return on Assets
Solvency	*Debt to Equity*	Assess leverage of corporation's funding and dependence on liabilities
	Debt Coverage Ratio	EBIDTA divided by the sum of short term debt, long term debt and financial leases
Debt Structure	*Currency risk*	
	Interest rate risk	Exposure to these three risks
	Re-financing risk	
Performance in meeting financial obligations to government	*Timeliness in Meeting Repayments due*	In Distress or Not in Distress

1.1.2 Financial risk factors

The Financial Risk Profile assessment of the GBEs is based on a number of financial ratios, such as:

1. Liquidity
2. Profitability
3. Solvency
4. Debt Structure
5. Performance in Meeting Financial Obligations to Government

The first three (Liquidity, Profitability and Solvency), are measured quantitatively, while the remaining two (Debt structure and Performance in Meeting Government Obligations) are qualitative measures (see ***Table 2***)

1.2 Information Requirements

Potential Borrowing Entity should submit financial performance data (i.e., cash flow statements, profit and loss accounts, balance sheet and annual report) for the past 3 years and a forecast of 3 years, together with economic and financial feasibility analysis of the loan that is requested.

1.3 Scoring and Weighting the Indicators

1.3.1 Scoring

The financial risk indicators assume a score range between 1 and 5, whereas the business risk indicators assume a range between 1 and 4.

Rating/Scores	Risk Level
1	Low Risk
2	Moderate Risk
3	Elevated Risk
4	High Risk
5	In Distress

The total weighted score obtained can be used in assessing credit worthiness of an Enterprise and to make a decision on whether to offer a loan or not.

1.3.2 Weighting

The weighting shows the priority ranking of the indicator. For example, if liquidity indicators are deemed to be more important than solvency indicators, a greater weight should be assigned to liquidity indicators. All weights must add up to 100 per cent. In the absence of a predetermined priority, weights can be assigned in an equal proportion. Correspondingly, if financial indicators are judged to be more important than business indicators then financial indicators will be assigned a greater weight.

For illustration, the World Bank's Guidance Note ratios for of Business risk and Financial risk of 45% : 55%, are used to derive a weighted scoring as shown in Table 3.

Table 3: Illustration of Risk Weighting

Factors	Weights	Individual score	Weighted score
Business Risk (45%)			
Regulatory Environment	15%	1	0.15
Sector Risk and competitive position	15%	2	0.30
Governance and Management	15%	2	0.30
Financial Risk (55%)			
Liquidity	10%	1	0.10
Profitability	10%	2	0.20
Solvency	15%	2	0.30
Debt Structure	10%	1	0.10
Meeting Government Obligations	10%	1	0.10
Total Risk	**100%**	**Overall weighted Score**	**1.55**

1.4 Decision on Loan Offer

Having obtained the overall weighted score, the following numeric scales are used in deciding whether or not to offer a loan.

Low Probability of default	Moderate Probability of Default	High Probability of Default
\`Offer Loan'	\`Re-assess Credit Risk and Re-consider'	'Do not offer Loan'
1 ⟷ 2	2 ⟷ 3	3 ⟷ 5

The above example with the overall weighted score of 1.55 falls under the category of \`Offer Loan'.

1.5 Risk Quantification - Probability of Default (PD)

After obtaining an overall weighted score, the next step is to convert the score to a Probability of Default. This can be done in several ways, e.g., using statistical methods, through domestic or international rating agencies [e.g., Standard & Poors (S&P), Moody's Investor Service (Moody's, Fitch etc.]

- Where the country does not regularly carry out international rating exercises, statistical methods or domestic rating could be used.
- For countries that regularly carry out international rating agency exercises, the overall weighted score is to be converted into an equivalent rating grade and the applicable probability of default for that rating grade is to be applied, as shown in the following example.

For example, the Risk Ratings for GBEs by S&P are provided in the Table 4, below.

Table 4: Estimating PDs Using S&P Credit Ratings

Risk Rating Scores	S&P Rating	Probability of Default
1	BBB	0.15%
2	BB	0.5%
3	B	3%
4	CCC	28%
5	D	100%

1.6 Expected Losses

Expected Losses can be estimated at the initial assessment stage for the loan or during every repayment due date of the loan.

1.6.1 Expected Loss Given Default

Expected Loss is determined by the following equation:

Expected Loss Given Default = Total Exposure x Probability of Default x (1-Recovery Rate)

Where:

Total Exposure = Loan Outstanding
Probability of Default = a numerical probability value between 0 and 1
Recovery Rate = Percentage that can be recovered of the total expected loss

1.6.2 Annual Risk Status

The Annual Risk status provides information on whether the loan repayments are under stress. This is represented by 'Net Present Value of Expected losses' (applied to all payments due each year)

Net Present Value of EL at each year = Σ discounted Expected Losses each year

1.7 Project related financial forecasts

Reviewing the financial and economic feasibility studies that contain forecasts can add value to the credit risk assessment exercise.