GOVERNMENT ON-LENDING FRAMEWORK

FOR THE

REPUBLIC OF THE GAMBIA

March, 2024

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Abbreviations

DLDM	Directorate of Loans and Management Office
DSA	Debt Sustainability Analysis
Commercial SOE	Commercial State-Owned Enterprise
GoTG	Government of The Gambia
IMF	International Monetary Fund
LGA	Local Government Authorities
MDA	Ministries, Departments and Agencies
MOFEA	Ministry of Finance
MOF	**Ministry of Justice**
PFA	Public Finance Act, 2014
PE	Public Enterprises
SOE Commission	State-Owned Enterprises Commission

Definitions

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, and/or fees.
“State-Owned Enterprise” or “Public Enterprise”	A body corporate or other body or institution, wholly owned or controlled by the Government as defined in section 175(1) of the Constitution of the Republic of The Gambia, 1997.
Loan Agreement	Formal documentation of the loan arrangement.
On lending	The process where the government borrows funds by way of a principal loan agreement (the “PLA”) from a foreign government or an international agency and on-lends these via a subsidiary loan agreement (the “SLA”) to an entity. The PLA is executed by the Minister of Finance on behalf of the government as the borrower, and the SLA is executed between the government and the entity as implementing agency upon terms and conditions agreed with the government
Commercial SOE	A body corporate or other institutions wholly owned or controlled by the Government, established to carry out commercial activities as defined in the State-Owned Enterprises Act, 2023.

SECTION 1: INTRODUCTION

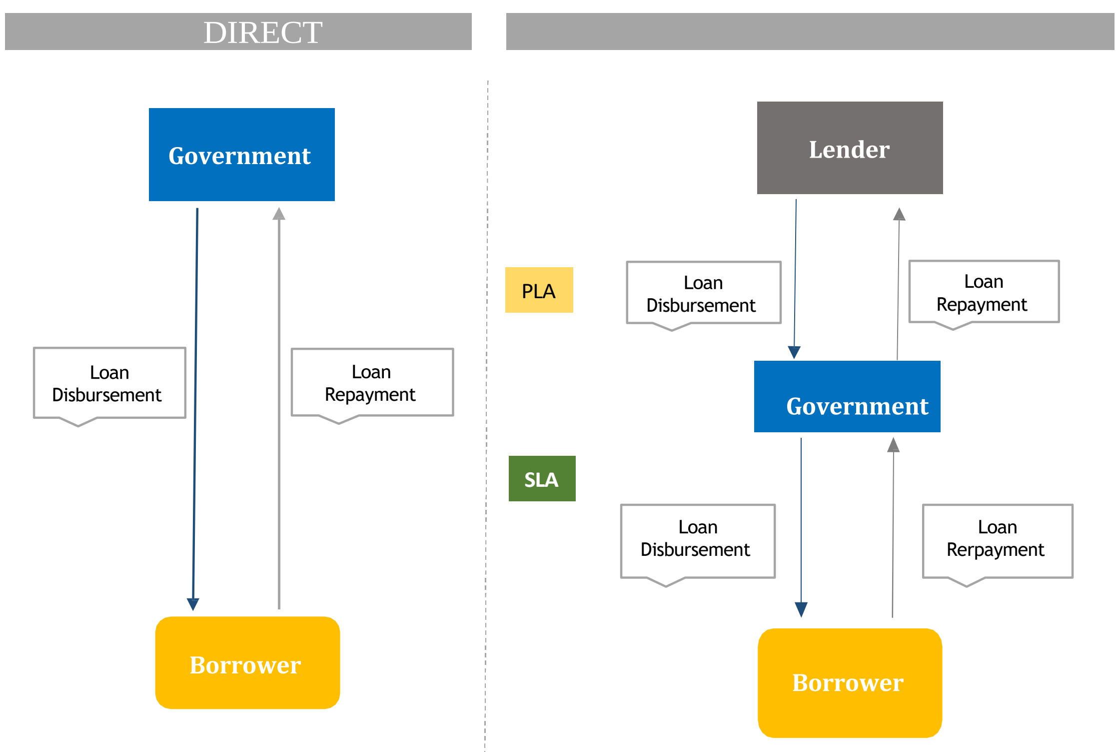
1.1. Purpose

Over the years, the government has provided loans to State-Owned Enterprises (SOEs), particularly those established to carry out commercial activities 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 fulfil their obligations have posed significant fiscal and reputation risks to the government's operations.

In accordance with section 155 of the Constitution of the Republic of The Gambia, 1997, and in line with section 35 of the Public Finance Act, the Minister of Finance has the sole authority to borrow on behalf of the State, both in The Gambia and abroad and in local and foreign currencies, and to sign loan agreements. This Government Lending Framework provides coherent guidelines to govern arrangements for the provision of direct loans and on-lending to public, private and foreign entities. By managing the fiscal risks associated with these lending activities, the Framework supports the government's achievement of fiscal resilience and public debt sustainability over the long term.

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

Figure 1: Typical Lending Flow Diagram



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 resources to Commercial SOEs or Public Enterprises, with terms and conditions stipulated in the loan agreement. Also included are government-guaranteed loans to all Public Enterprises and Commercial SOEs 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 Commercial SOE, Public Enterprise 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 Framework are to:

- provide operational clarity to all 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.
- ensure that the usage of funds are to finance capital expenditure and liquidity of projects in line with government priorities in the promotion of economic development.

1.4. Scope

The scope of the Framework is to provide evaluation and decision-making guidance for prospective loan beneficiaries, the DLDM, MOFEA, SOE Commission, Line Ministries, Cabinet, National Assembly and MOJ, with respect to requests for government loans.

The Framework shall apply to loans to Public Enterprises, Commercial SOEs, private domestic companies and foreign entities—the latter two categories on an exceptional basis, only.

Exclusions to the 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 supported by input from the Ministry of Finance.
- ***Loans for Public-Private Partnerships (PPPs)***—which are issued as part of a risk-sharing arrangement to improve 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 DLDM is to:

- administer the 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 PFA.
- review the Framework, at least every five years, to ensure ongoing relevance and alignment with applicable standards and legislation, and experience gained in implementing the framework.

Any amendments recommended by the Director, DLDM (the "Director"), are to be provided to the Minister of Finance (the "Minister") through the Permanent Secretary for Cabinet's approval. Thereafter, the amended Lending Framework is to be published before coming into effect.

SECTION 2: LEGAL AND INSTITUTIONAL FRAMEWORK

2.1. Legal Framework

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

- The Constitution of the Republic of The Gambia, 1997
- Public Finance Act, 2014
- State-Owned Enterprises Act, 2023

2.2. Objectives

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 commercial SOE for a period of up to one (1) year.
- To support the implementation of development projects by entities, thereby allowing access to medium- to long-term financing options at a lower cost.
- A new loan offered as a recourse action to a guarantee that has been invoked.
- For a foreign government, the loan must be for the purpose of assisting the economic development of that country and for the welfare of its citizens.

2.3. Eligibility Criteria

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

- The Commercial SOEs, PEs or private entity 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 PEs/Commercial SOEs will be subjected to credit risk assessment process, as well as the capacity of the borrower to honor these obligations.

On lending proposals, to PEs, Commercial SOEs, Local Government Authorities and private or other entities 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. **PEs/Commercial SOEs**:
   - Be compliant with all provisions of the PFA—including reporting requirements.
   - Have no Social Security 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 social security 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 Gambia and would not otherwise be developed by a Commercial SOE, PE 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 government debt arrears.
   - Have no tax arrears.
   - Have no social security contribution arrears.

2.4. Governance and Institutional Framework

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

- National Assembly
- Cabinet
- Ministry of Finance and Economic Affairs— (the Minister and the Permanent Secretary)
- Directorate of Loan and Debt Management (Director, Front, Middle and Back Office)
- Ministry of Justice (MOJ)
- Ministries, Departments and Agencies (MDAs)
- Public Enterprise
- Commercial State-Owned Enterprises
- SOE Commission
- Other

2.4.1. Roles and Responsibilities

a) National Assembly

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

b) Cabinet

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

c) Directorate of Loan and Debt Management

- maintain timely and comprehensive records and database of all loans—recording loan disbursements, and repayments.
- use the loan database to generate invoices for billing entities of repayments 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 Permanent Secretary for transmission to the Minister.
- facilitate the recovery of any repayments, including interest and other costs incurred by the Government, due to the honouring of lending activities.
- prepare annual reports on outstanding lending by the government.
- review proposals for issuance of loans.
- to carry out credit risk assessments

d) Director, DLDM

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

e) Ministry of Finance

The Minister has the power to issue loans subject to National Assembly ratification.
The Permanent Secretary is to:

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

f) Accountant General's Department

the Accountant General is to:

i. Prepare, sign and transmit to the Auditor-General to audit a statement of loans issued by the government.
ii. oversee the disbursement of public funds.
iii. report on the financial position of the government.

g) Ministry of Justice

Assist with the drafting and review of all draft loan documents.

h) Line Ministries/SOE Commission

i. Conduct initial reviews of all loan applications from PEs, SOEs LGA and private entities as applicable.
ii. Assist with the overall monitoring and reporting requirements for loans.

i) SOE Commission

i. Conduct initial reviews of all loan applications from Commercial SOEs.
ii. Assist with the overall monitoring and reporting requirements for loans.

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.

a) The stock of government loans shall be a percentage of nominal gross domestic product, as determined by the Fiscal Strategy Framework and debt sustainability considerations.

b) 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.

c) For a new company/private sector firm or SOE 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***:

a) The posting of collateral—in the case of non-public sector entities and public sector entities having less than 100% ownership by the government.

b) Restricting the use of loan proceeds to the investment project only.

c) Submission of regular reporting on the investment project, along with audited financials and ad hoc financial reports.

d) Restrictions on future borrowings—depending on the outcome of the credit risk assessment exercise.

e) Execution of a formal loan agreement, with terms and conditions to be agreed with the government.

f) The government's borrowings from the primary lenders, 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 DLDM 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.

g) Repayments to be made in domestic currency or foreign currency equivalencies to match debt servicing obligations.

h) 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. 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 DLDM will provide the Ministry of Justice ("MOJ") 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*:

i) follow a standard format as prepared by MOJ.

j) outline the responsibilities of all parties (i.e., the government and the Borrower) and the terms and conditions.

k) specify all reporting requirements of the Borrower.

l) be issued for the period of the loan.

m) include any conditions and criteria the government, at its discretion, deems appropriate.

3.5. National Assembly and Other Requirements for Loans

The National Assembly shall approve the lending of funds to local government authorities, Public Enterprises, and any other Entities.

SECTION 4: GUIDELINES FOR GOVERNMENT LENDING

4.1. Introduction

The need for a government loan by borrowers (Public, private and foreign entities) could be identified during meetings with the Ministry of Finance and Economic Affairs.

- All requests for government <u>short–term liquidity support loans</u> to Commercial SOEs/PEs will be subject to an internal review by the Ministry of Finance.
- All requests for <u>on-lending</u> by the government will 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 MOFEA, entities are expected to submit their requests during the time of the annual ***Budget Call Circular*** exercise. However, the government recognizes that there may be exceptions to this timeframe, in which case these requests will be considered on a case-by-case basis.

4.2. Lending Application Procedures

a. Direct Loans

Applications from PEs, SOEs or LGAs for short-term liquidity support must be submitted through the Line Ministry 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 MOFEA to the attention of the Permanent Secretary.

- Applications from PEs, LGAs, Private or other entities must be submitted through the Line Ministry and in the case of Commercial SOEs to the SOE Commission and Line Ministry who are expected to confirm, before forwarding to the MOFEA, whether:
    - the loan requested satisfies national priorities—in keeping with the objectives outlined in sections 2.3 and 2.3.1, above.
    - all other potential funding opportunities were well examined.
    - 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 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 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 line 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 DLDM reserves the right to request additional information and, where deemed necessary, the applicant will be required to make a formal presentation.

4.3. Loan Evaluation and Credit Risk Assessment

The Permanent 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) DLDM

- 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.
- Once the application is deemed to be complete, the Director may require applicants to make formal presentations of their requests.
- 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.
- 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. A model will be developed to calculate the premium for credit risk assessment.
    - the request could be considered within the limit established for the overall stock of loans.

Upon completion of its review process, the DLDM 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 DLDM, via the Director, will submit the Report to the PS for consideration.

4.4. Final Approval of Loan Application

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

The Minister's final decision will be communicated to the DLDM, via the Permanent Secretary.

4.5. Notification of Decision(s) To Applicants

The PS will communicate, in writing, the final decision of the Minister on the loan application.

- In the case of an PE or Commercial SOE, decisions will be forwarded directly to the SOE Commission /Line Ministry and copy the PE or Commercial SOE
- 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. **DLDM/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 of the loan transactions promptly 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 annual reports (December) on loans for the Minister to present to National Assembly.

- Publish information on loans as part of the government's quarterly Fiscal Reports.
- In the case of default, the DLDM should recommend to the Minister via the PS, for Cabinet's final decision, on what recourse action should be taken.

Figure 2: DLDM's Responsibilities for Government Lending Management

Portfolio Management	Policy & Risk Management	Debt Operations
• Receiving applications • Assessing applications against pre-set criteria • Presenting applications to the Technical Committee for risk assessment • Drafting loan letters • Evaluating loan requests	• Conduct credit risk assessment for applications • Conducting credit risk assessments for a portfolio of loans • Estimating loan fees	• 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 DLDM 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 DLDM.
- Ensure that all loans are reviewed annually, and copies of reviews forwarded to the DLDM, via the SOE Commission/Line Ministry.

c. SOE Commission/Line Ministry:

Monitor whether the PE/Commercial SOE 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 DLDM.

SECTION 6: EVENT OF DEFAULT

A default is deemed to occur if the borrower fails to pay in accordance with 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, 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 OF ON-LENDING

7.1. **CREDIT RISK ASSESSMENT**

Credit risk assessments help to evaluate how creditworthy 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 the Government.
- Business risk indicators are categorised 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 scores assigned by the credit rating agencies.
- Rating agencies usually have a numerical value of the probability of default attached to their alphabetic grading structure.

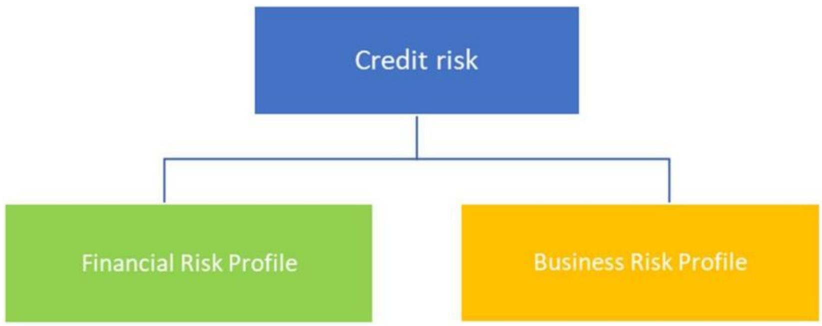
7.4. EXPECTED LOSS

- Expected loss estimations are to be jointly carried out by the staff of the DLDM and the Accountant General's Department. The methodology for estimating Expected Loss is provided in Annex 1.
- Expected loss estimates may be used for budget provisioning and for estimating contingency reserves, where deemed appropriate.

Annex 1: Credit Risk Assessment: A Credit Scoring Approach

1.1 RISK INDICATORS

On-lent loans to Commercial SOEs, PEs 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 the 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 indicator, 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. The selection of business and financial risk indicators will depend upon the sector/area of operation of the prospective Borrowing Entity. The availability of data, information, resources, and the capacity of the staff to carry out this exercise will also influence the application of the model. Benchmark ranges shall be used for the assessment or scoring of the financial ratios and the benchmark ranges shall be adjusted for each sector from time to time.

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 management of the borrowing Entity/SOE provided as 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	▪ Are there relevant laws and regulations with regard to the industry and enterprise? ▪ Does the legal environment allow for 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 on 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 the corporation's funding and dependence on liabilities
	Debt Coverage Ratio	EBITDA 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 SOEs 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 ⟷ 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 SOEs by S&P are provided in 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%

1.2.EXPECTED LOSSES

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

1.2.1. 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

1.2.2. 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

1.3. PROJECT-RELATED FINANCIAL FORECASTS

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

>>THE END<<