Investment Readiness Toolkit for Financial Institutions in Sierra Leone

INVEST SALONE

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Abbreviations and acronyms

ALCO	Asset-liability Committee
BSL	Bank of Sierra Leone
CEO	Chief Executive Office
CFO	Chief Financial Officer
COO	Chief Operating Officer
CRO	Chief Risk Officer
NPL	Non-Performing Loan
PAR	Portfolio At Risk

1 Introduction

Some credit institutions in Sierra Leone may benefit from accessing wholesale funding to expand their lending to the real economy. International financial institutions (including both multilateral and bilateral development finance institutions) may be a suitable source of additional finance, especially if it comes at a concessional price.

However, to access this finance a credit institution needs to be well prepared to assure lenders that it represents a creditworthy counterpart. Some credit institutions have had little experience in corporate finance and the process may be relatively new to them. This toolkit is designed to help credit institutions understand the criteria that institutional lenders may use to assess the viability of a transaction.

The toolkit is designed for deposit-taking institutions such as commercial banks, community and rural banks, and deposit-taking microfinance institutions of relatively modest size, with straightforward corporate structures, and conventional business and operating models.

It presents model financial statements based on a real second-tier commercial bank in a frontier market like Sierra Leone. This simplified template may be a useful guide for those looking to "decomplicate" their financial statements, which may have become increasingly difficult to analyse as they have become more granular.

In the first instance, a likely lender is going to be interested in the big picture rather than breakdowns of reserves, depreciation treatment and tax accruals or deferrals etc. One of the most common and well-established approaches used to assess the financial soundness of a credit institution is the CAMELS model, used by both regulators and wholesale lenders.

2 CAMELS

The CAMELS model is well known and widely applied but is not the only model that lenders will use to make credit assessment decisions. However, it is a sound basis for preparing a credit institution to access wholesale funding.

Note that while it is useful for debt transactions, it is not so applicable for equity investment valuations. While having a financially robust institution is a major asset, equity valuation models reflect the wider opportunities in the market that may present an equity upside for investors, especially those looking to take an active management role.

The key elements of the CAMELS model are described below.

2.1 Capital

Capital protects an institution (most notably its depositors) against unexpected losses. It is the foundation of financial soundness. The appropriate level of capital will vary between institutions and markets, and it needs to be considered in context. Regulatory capital is that required of an institution by the banking supervisor or other regulatory authority. This is closely related to but a different concept from economic capital, which is required to underpin the institution's current business model and strategic plans.

2.2 Assets

Asset quality is a major determinant of financial soundness. In a credit institution, typically the most significant asset is the loan portfolio. Therefore, assessing the riskiness of a loan book is a key element in the evaluation. Other types of securities may also present significant credit or market risks. Other items such as fixed assets may be at risk of devaluation or losses through damage, so should not be neglected.

2.3 Management

The expertise, experience and integrity of the owners and management of a credit institution are critical to its overall creditworthiness. Most of the assessment of this perspective is subjective, so good preparation and presentation are critical.

2.4 Earnings

Robust earnings should absorb normal and expected losses and underpin internal capital generation. This capital is key to equity valuation, the issuance of which can act as a backstop for creditworthiness if necessary.

2.5 Liquidity

Liquidity is the ability of a credit institution to meet short-term obligations (most notably deposit demands) while also continuing to fund the demand for loans by borrowers.

2.6 Sensitivity

Sensitivity is an indication of the level of volatility attached to the institution, with particular reference to earnings, which generate internal capital, and deposits, which largely fund the loan book.

3 Hypothetical financial statements

To best illustrate the practical assessment of the creditworthiness of a credit institution, some hypothetical financial statements have been prepared. These financial statements are almost an exact facsimile of those from a small commercial bank in a frontier market. While potential wholesale lenders may require data in a slightly different format, or wish to drill down to further detail, the layout below is a good guide for simplifying the financial statements and focusing on the items of most interest.

ASSETS	SLE k	SLE k
Cash and cash equivalent (including balance w/BSL)	271,923	304,551
Amounts due from other banks	66,105	120,741
Government Treasury bills	364,499	423,866
Money market investments	125,000	100,000
Loans and advances	1,509,488	1,377,978
> Short-term loans	1,235,555	919,703
> Non-performing loans (>90 days PAR)	54,354	44,025
Equity investments	N/A	N/A
Derivative assets	594	2,028
Other assets	93,263	99,285
Fixed assets	48,660	48,910
Intangible assets	8,021	2,765
Tax assets	29,947	28,637
TOTAL ASSETS	**2,517,500**	**2,508,761**
RISK-WEIGHTED ASSETS	**1,548,247**	**1,280,114**

LIABILITIES	SLE k	SLE k
Liabilities to customers	1,596,505	1,504,480
> Demand deposit	997,957	917,438
> Time deposit	211,245	160,604
> Savings deposit	387,303	426,438
Liabilities to other banks	219,379	189,913
Other liabilities	113,001	140,561
Borrowings	250,000	375,000
> Short-term borrowings	125,000	125,000
Subordinated debt/debt securities	32,067	31,997
Provisions	5,463	4,659
Current tax	N/A	N/A
Deferred tax	N/A	N/A
TOTAL LIABILITIES	**2,216,415**	**2,246,610**

CAPITAL AND RESERVES	SLE k	SLE k
Paid-in capital	15,700	15,700
Share premium account	71,300	71,300
Retained earnings	209,755	169,734
Consolidated reserves	4,330	5,417
Total capital and reserves	301,085	262,151
> Tier 1 capital	270,438	236,362
> Capital adequacy ratio	20%	17%
TOTAL LIABILITIES AND EQUITY	**2,517,500**	**2,508,761**

INCOME STATEMENT	SLE k	SLE k
Interest income	184,936	163,616
(Interest expense)	31,731	30,916
Net interest income	153,205	132,700
Non-interest income	66,207	65,234
Total income	219,412	197,934
(Operating expenses)	152,025	157,697
> Number of employees	950	1,005
Operating profit	67,387	40,237
(Net charge on impaired loans and advances)	7,331	33,941
Profit before tax	60,056	6,296
(Tax)	20,035	29,587
NET PROFIT	**40,021**	**(23,291)**

4 Capital

The model described below is typical of a credit rating tool that might be applied by a wholesale lender to financial institutions. It is known as an "expert judgement" model, which combines financial and non-financial criteria under the CAMELS framework to help an analyst reach a sound credit decision. There is considerable scope for subjectivity, and it relies heavily on the expertise and experience of the analyst.

Most models will usually come with some sort of scoring matrix. This has not been included in this toolkit, as scoring will vary depending on the market and the risk appetite of the lender. Regardless, the criteria being evaluated are universally relevant and should be a very useful guide to potential borrowers in discussing the creditworthiness of their institution.

4.1 Financial ratios

RATIO	FORMULA		
Total borrowings/total equity (ratio)	$= \dfrac{\text{Borrowings}}{\text{Total capital and reserves}}$	$= \dfrac{250{,}000}{301{,}085}$	= 0.83
Total equity/total assets (percentage)	$= \dfrac{\text{Total capital and reserves}}{\text{Total assets}}$	$= \left(\dfrac{301{,}085}{2{,}517{,}500}\right)\%$	= 12.0%
Capital adequacy ratio (percentage)	= Capital adequacy ratio	= 20%	= 20%
Tier 1 capital	= Tier 1 capital	= SLE 270,438	= SLE 270,438

4.2 Non-financial criteria

CRITERIA	LINES OF ENQUIRY
Capital adequacy	What is the adequacy of the level of capital in relation to regulatory minimums, peers, the institution's overall risk profile and its strategic direction?
Capital quality	Are the types and mix of capital instruments and the level of high-quality capital appropriate?
Capital backstopping	Are the shareholders willing and able to assist the institution in maintaining regulatory capital or the ability of the institution to raise capital externally?
Capital management policy	How appropriate are the capital management policies and practices?
Capital planning	How adequate is the capital planning process (including scenario analysis and stress testing), and does the capital plan underpin future resilience?
Capital reporting	Do the capital reporting policies and practices provide complete, accurate and timely reports on the institution's capital management to enable senior management and the Board (or a Board committee) to assess compliance with: a) The institution's capital plan, including the results of scenario testing? b) Regulatory capital requirements?

5 Assets

5.1 Financial ratios

RATIO	FORMULA
Non-performing loans (percentage)	$= \frac{\text{Non-performing loans}}{\text{Loans and advances}} = \left(\frac{54{,}354}{1{,}509{,}488}\right)\% = 3.6\%$
Return on assets (percentage)	$= \frac{\text{Annualised net profit}}{\text{Average total assets}} = \left(\frac{40{,}021}{(2{,}517{,}500 + 2{,}508{,}761)/2}\right)\% = 1.6\%$

5.2 Non-financial criteria

CRITERIA	LINES OF ENQUIRY
Credit assessment	How adequate are the underwriting standards, credit administration and risk identification practices?
Stressed assets	What is the level, distribution, severity and trend of problem assets (classified as non-accrual, restructured, delinquent and non-performing) for both on- and off-balance-sheet transactions? Does the management have the ability to properly administer its assets, including the timely identification and collection of problem assets?
Asset valuation and provisioning	How adequate are the valuation and provision policy and related reserves?
Off-balance-sheet risk	What credit risks arise from or are reduced by off-balance-sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit?
Asset diversification	To what extent is the loan and investment portfolio diversified?
Trading counterparty exposure	What is the extent of securities underwriting activities and exposure to counterparties in trading activities?
Credit policy	How adequate are the loan and investment policies, procedures and practices?
Credit reporting	How adequate are the internal controls and management information systems?

6 Management

6.1 Financial ratios

RATIO	FORMULA
Earnings per employee	$= \dfrac{\text{Annualised net profit}}{\text{Number of employees}} = \dfrac{40{,}021}{950} = \text{SLE k } 42$
Cost-income ratio (percentage)	$= \dfrac{\text{Operating expenses}}{\text{Total income}} = \left(\dfrac{152{,}025}{219{,}412}\right)\% = 69.3\%$

6.2 Non-financial criteria

CRITERIA	LINES OF ENQUIRY
Shareholders	Financial strength and reputation of the major shareholders.
Board composition and qualifications	Appropriateness of Board size, range of directors' qualifications, knowledge, skills and experience, and level of commitment available to fulfil Board responsibilities.
Senior management composition and qualifications	Appropriateness of senior management team (CEO, CRO, CFO, COO), range of qualifications, knowledge, skills and experience, and level of integrity.
Market intelligence	Anecdotal evidence or reportage on the general reputation and compatible values and behaviours of beneficial owners, shareholders, directors and senior managers.
Corporate governance policy and practice	Suitability of documented corporate governance process and evidence of application of good practices.
Capacity of internal audit function	Independence, integrity and expertise of internal audit function and evidence of robust reporting.
Capacity of risk management function	Independence, integrity and expertise of risk management function and evidence of strong critical analysis.
Planning policy and practice	Adequacy of policies and practices to establish business objectives, strategies and plans, and to monitor the institution's performance against them.
Reporting	Adequacy of management reporting to foster good evidence-based decision-making.

7 Earnings

7.1 Financial ratios

RATIO	FORMULA		
Return on equity (percentage)	$= \frac{\text{Annualised net profit}}{\text{Total capital and reserves}}$	$= \left(\frac{40{,}021}{301{,}085}\right)\%$	= 13.3%
Net interest margin (percentage)	$= \frac{\text{Annualised net interest income}}{\text{Interest earning assets}}$	$= \left(\frac{153{,}205}{2{,}065{,}092}\right)\%$	= 7.4%
Interest earning assets	= Amounts due from other banks + Government Treasury bills + Money market investments + Loans and advances	= 66,105 + 364,499 + 125,000 + 1,509,488	= 2,065,092

7.2 Non-financial criteria

CRITERIA	LINES OF ENQUIRY
Adequacy of earnings	How adequate are the earnings relative to the risk profile of the institution?
Quality of earnings	How volatile are the sources of earnings?
Trend and volatility of earnings	Are the earnings showing stable growth?
Diversity of earnings	How diversified are the sources of earnings?
Comparability of earnings	How is the institution performing in relation to peers?
Vulnerability of earnings	How vulnerable are the earnings to competitor positioning?
Economic/market sensitivity of earnings	How protected are the earnings from major negative economic events?
Dependence on earnings	To what extent does the financial soundness of the institution rely on its earnings?

8 Liquidity

8.1 Financial ratios

RATIO	FORMULA		
Short-term assets/liabilities (percentage)	$= \dfrac{\text{Short-term assets}}{\text{Short-term liabilities}}$	$= \left(\dfrac{1{,}938{,}082}{1{,}940{,}884}\right)\%$	= 99.9%
Loan/deposit ratio (percentage)	$= \dfrac{\text{Loans and advances}}{\text{Liabilities to customers}}$	$= \left(\dfrac{1{,}509{,}488}{1{,}596{,}505}\right)\%$	= 94.5%
Short-term assets	= Cash and cash equivalent + Amounts due from other banks + Government Treasury bills + Money market investments + Short-term loans	= 271,923 + 66,105 + 364,499 + 125,000 + 1,235,555	= 1,938,082
Short-term liabilities	= Liabilities to customers + Liabilities to other banks + Short-term borrowings	= 1,596,505 + 219,379 + 125,000	= 1,940,884

8.2 Non-financial criteria

CRITERIA	LINES OF ENQUIRY
Diversity of customer deposits	Are the number, level and diversity of deposits adequate, and is concentration risk in a small number of similar depositors low?
Stickiness of customer deposits	Can the “stickiness” of deposits be evidenced, and does the institution have proactive customer relationship, product and channel management strategies, taking particular note of the importance of time-bound deposits?
Level and security of short-term borrowing	Are the levels of short-term borrowing and planning for major rollovers of long-term funding suitable?
Liquid assets	Are the level, quality and availability of liquid assets relative to general coverage (forecast cash outflows) adequate?
Contingent credit lines and liquidity	Are the contingent liquidity and undrawn credit lines adequate?
Asset-liability Committee (ALCO) and maturity risk management	How effective is the ALCO in liquidity risk management generally?

9 Sensitivity

9.1 Financial ratios

RATIO	FORMULA
Earnings volatility (percentage)	$= \text{ABS}\left(\frac{\text{(Profit before tax current - Profit before tax previous)}}{\text{Profit before tax previous}}\right)\% \quad = \text{ABS}\left(\frac{60{,}056\text{-}6{,}296}{6{,}296}\right)\% \quad = 853\%$
Deposit volatility (percentage)	$= \text{ABS}\left(\frac{\text{(Liabilities to customers current - Liabilities to customers previous)}}{\text{Liabilities to customers previous}}\right)\% \quad = \text{ABS}\left(\frac{1{,}596{,}505 - 1{,}504{,}480}{1{,}504{,}480}\right)\% \quad = 6.1\%$

9.2 Non-financial criteria

CRITERIA	LINES OF ENQUIRY
Earnings	How is the overall level (and particularly stability) of earnings, considering both net interest and non-interest income?
Deposits	Is the overall level, diversity, quality and “stickiness” of customer deposits (particularly retail) appropriate?
Wholesale funding	Are the volumes of wholesale finance, with a focus on the term, pricing and diversity of funding, appropriate?
FX exposure	Are the levels of foreign exchange exposure well measured and monitored (with suitable hedges in place if required), proportionate and manageable?
Interest rate exposure	Are the levels of interest rate exposure well measured and monitored (with suitable hedges in place if required), proportionate and manageable?
Market volatility	Are the levels of exposure to securities and investment markets (incorporating equities, bonds, currencies, commodities and all derivatives) proportionate?
Customer base	Is the customer base for liability, asset and transaction-based products well diversified and suitably robust?

10 Next steps

The above model is a useful self-assessment guide that credit institutions in Sierra Leone can use to prepare to access wholesale finance. When undergoing self-evaluation, it is important that a credit institution can also identify positive and negative trends, which will mean evaluating performance over a sequence of financial statements.

Development financiers are realistic and do not expect a potential borrower to exhibit perfect performance. Banking is difficult, especially in a frontier market like Sierra Leone. When pitching for wholesale facilities, it is important to ensure that the business plan identifies both positive and negative features of an institution’s performance. In relation to the latter, it should explain clearly the remedial actions intended to address areas of weakness. A robust assessment of creditworthiness and a clear strategy for improving it will put an institution in a much better position in negotiations.

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