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CABRI virtual training event
with selected West African countries
9–10 March 2021

Improving the application, approval and monitoring processes of government guarantees

SUMMARY REPORT

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Acronyms and abbreviations

CL	contingent liability
PPP	public-private partnership
SOE	state-owned enterprise
OHADA	Organisation for the Harmonisation of Corporate Law in Africa

Acknowledgements

This summary report was made possible from discussions held with selected West African countries during the CABRI virtual training event (9–10 March 2021) on improving application, approval and monitoring processes of government guarantees. Johan Krynauw (CABRI) was responsible for compiling the report with inputs from Nicole Kearse and Rita Madeira (African Legal Support Facility, ALSF), Lerzan Ülgentürk (CABRI consultant), Mr Hamado Seogo (Head of the Unit of Studies and Debt Management Systems within the Public Debt Office, Ministry in Charge of Finance, Burkina Faso) and Anthony Julies (former Head of Asset and Liability Management Division, National Treasury of South Africa). On behalf of CABRI, we would like to thank participants for their valuable contributions.

Introduction

Following CABRI's peer-learning event on the risks posed by contingent liabilities to national budgets in Africa during September 2020 (visit www.cabri-sbo.org to view case studies, policy brief and other documents), CABRI held a follow-up training event, upon request, aimed at strengthening the application, approval and monitoring processes for government loan guarantees.

Key takeaways from the September 2020 event emphasised the importance of developing necessary capabilities to manage contingent liabilities and for governments to take a 'hard look' at their own processes prior to demanding compliance from others.

The training event focused on guidelines/procedures and strengthening institutional arrangements in the application and monitoring processes of government guarantees. A questionnaire designed to engage discussions on progress made was prepared and completed by seven countries. As part of the peer-learning experience and in preparation for the event, participants were provided with study notes on 'conceptual framework' and relevant country examples.

The training event was attended by 31 participants representing nine countries, mainly from West Africa. The participating countries were Burkina Faso, Benin, Côte d'Ivoire, Liberia, Mali, Morocco, Senegal, South Africa and Togo. Support was provided by the African Legal Support Facility hosted by the African Development Bank, a former official of the Turkish Public Debt Office and the Asset and Liability Management (ALM) division (including the former head of ALM) of the National Treasury of South Africa.

The programme was comprised of four sessions, as follows:

- A broad overview of contingent liabilities, with an emphasis on the 'importance and better understanding of the management of contingent liabilities'
- A questionnaire analysis on the 'issuance and monitoring processes of selected West African countries'
- How Burkina Faso created an 'institutional environment for managing guarantee issuance and monitoring processes with a risk-management approach'
- A role-play exercise designed to simulate a guarantee application, credit risk assessment and recommendation for approval processes.

The training event focused on guidelines/procedures and strengthening institutional arrangements in the application and monitoring processes of government guarantees

Session 1

Broad overview of contingent liabilities, with an emphasis on the 'importance and better understanding of the management of contingent liabilities'

This session provided a broad discussion on the risks posed by contingent liabilities on governments' public finances, which should be properly assessed, mitigated and managed through appropriate frameworks and tools.

Contingent liabilities (CLs) are considered to be one of the largest sources of fiscal risk – they can lead to large increases in public debt and contribute to the triggering of fiscal crises, to the extent that they represent a potential financial claim against the government should a particular event or events occur. However, the actual fiscal cost and timing of the cost being payable largely remains uncertain until the triggering event materialises.

A common misconception about CLs is the belief that they do not represent a cost to the government, as they are regarded as 'off-balance sheet' transactions. In this sense, they can be deceiving and are often referred to as 'hidden deficits', in other words, 'increases in public debt that are not explained by headline fiscal balances'.

When CLs are not identified, captured, assessed, mitigated or managed, they can materialise without governments having taken appropriate mitigation measures or put in place the necessary mechanisms to address the risks. CLs often arise during times of economic stress.

Firstly, managing CL risks is critical, and risk assessments should be conducted regularly. If not properly identified and mitigated, CLs have the potential to negatively impact the government balance sheet and weaken the government's fiscal position.

In assessing the risk of CLs, it is important to consider the following key questions:

- What are the chances of the CL becoming a liability? Is it a probability, possibility or remote chance?
- How much will the materialised liability cost?
- What impact will materialisation have on the overall debt levels of the government and financial sustainability of the country

Secondly, it is important to understand what type of risks are involved. Usually, risks are classified as entity and/or project risks.

Regarding entity risks, the objective is to determine the entity's creditworthiness. In reviewing the entity's credit risks rating, the government should evaluate the possible impact the entity's default could have on the government's balance sheet. By using various statistical models or conducting scenario analysis, the government will be in a better position to understand the risks and associated obligations.

In the case of project risks, the government must assess the likelihood that the guaranteed project's revenue stream may be inadequate or the right to termination payment will be triggered. In the case of public-private partnerships (PPPs), the government should assess whether the risks have been correctly allocated (that is, whether the risks are managed by those parties most capable of managing them. Examples of these type of PPP-related risks include 'demand risks' and 'completion risks'. The potential impact of an 'exogenous event' on the project cash flow payment stream should also be considered.

Thirdly, the risk should be quantified, to better understand the potential impact of the CL on the sovereign's balance sheet. The risks are normally quantified and disclosed in the financial statements, either on 'face value', 'maximum loss value', 'expected cost' or 'market value'. Depending on the method used, the risks could be quantified in total. This requires prior agreement on accounting standards and principles, and a specialist accountant.

Fourthly, the impact of the risks should be determined (i.e. what could happen in a best- or worst-case scenario?). For this, stress tests and debt sustainability analyses can be applied.

Stress tests involve assessing the sensitivity of the government's fiscal health to the potential materialisation of the CL.

For this, governments/countries:

- May have a threshold on the total contingent liabilities outstanding in relation to total government debt
- May always assume the 'worse case' scenarios, taking a conservative view that if a certain area is impacted, it might impact other areas as well
- May conclude that certain levels of exposure are more acceptable than others.

Debt sustainability analyses:

- Can be used to assess how a country's current and prospective debt levels might impact its ability to meet its various debt-servicing obligations
- Can be used as an early-warning sign
- Are essential in assessing the potential impact of contingent liabilities in a country.

As part of the risk-assessment process, risks-cost-benefit analyses are conducted during the recommendation and approval process of the government guarantee application. While there is no 'golden rule', some of the key initial questions to ask regarding the decision on whether or not the guarantee application can be supported, are whether:

- The project is necessary, and
- A government guarantee is necessary for the project (note that a guarantee should address 'supply side' as well as the 'demand side' issues for the project to be financially viable)
    - Query whether the private sector addresses the need
    - Query whether 'external resources' like insurance may be used as an alternative
    - Query whether 'direct budget support' would be preferable.

Risk mitigation

Following the assessment and approval process, measures need to be put in place to mitigate the risks posed by the CLs.

As CLs pose a fiscal risk, measures to mitigate and manage such risks are usually presented as part of a strategy to address fiscal risks and even within broader debt management strategies. Specific risk-mitigation and management strategies or options available may vary from country to country. However, the key concerns and risks remain the same.

It is important to develop:

- Criteria and guidelines to support the decision as to whether CLs can be accepted
- Clear guidelines on how to allocate, transfer or share CL risks with the private sector to mitigate the impact of CLs on fiscal balances
- The capacity to manage risks aimed at minimising the impact when risks do materialise
- Good practices in disclosing and reporting CLs.

Common risk- mitigation tools include:

- Budget flexibility, contingent reserve funds, internal and external audits and various other 'safeguards' could be built into a risk-mitigation plan
- Setting a limit to the stock of CLs allowed to be issued, typically in the form of sovereign guarantees
- Overall ceiling limits on guarantees can stimulate comparisons and trade-offs among different guarantee application requests, thereby encouraging additional scrutiny and analysis (thus, such limits can be a direct and efficient tool to manage the impact of the guarantees being issued.
- Separate ceilings can be set on the overall size of the PPP programme (stocks) and/or on the annual PPP-related payments (flows), which can help limit the government's overall exposure to risks from PPPs.

Institutional arrangements

Institutional arrangements for CLs vary from country to country. The legal framework must be in place, both as a primary and a secondary management tool. Internal stakeholders may include the PPP unit, the debt management office, the audit function, and budget units. Parliamentary involvement may be required by law, either for information and oversight purposes only, or as a step towards approval or setting the overall net-capping and limits for sovereign guarantee exposure levels.

Disclosure

Finally, and most importantly, there is a trend towards increased disclosure of information relating to CLs. Specific requirements may vary depending on the applicable standards, but transparency is an important tool for all stakeholders.

Key findings from the discussions during Session 1 were:

- CLs can pose significant risks to the government
- In the assessment process, is important to first rank, identify the type of risk, quantify the risk, determine the impact of the risk, as well as undertaking a risk-cost-benefit analysis prior to the recommendation and approval processes
- Following the approval process, mitigation strategies in terms of gaps and limits must be considered
- Legal frameworks, as primary and secondary tools, must be in place to stipulate where the guarantee approval authorisation is, as well as setting out responsibilities for the development of guidelines, mandates, roles and other CL management responsibilities.
- Furthermore, it is important to disclose the risks that CLs pose by adopting the correct accounting and reporting standards, followed by good practices to enhance transparency enabling policymakers to make informed decisions.

Session 2

Questionnaire analyses on the government guarantees' issuance and monitoring processes of selected West African countries

To inform discussion during this session and to explore where countries are in terms of progress/challenges in issuing government loan guarantees, a questionnaire was forwarded to countries in the region, prior to the event.

Government loan guarantees are amongst the most common types of CLs. They are provided through financial contracts, in terms of which the government accepts part or the whole credit risk of a loan granted to a third party. Beneficiaries of government loan guarantees are mostly the state-owned enterprises (SOEs), sub-national governments and public and development banks.

When appropriately utilised and managed, guarantees prove to be efficient financial tools for governments, supporting various economic and social policy objectives, such as infrastructure development, export promotion, or real sector development. Guarantees may also be justifiable for balancing market imperfections. However, when the market failure is absent and the economic justification is weak, guarantees can be distortionary, in which case, a guarantee would become an implicit subsidy equivalent to its value.

A rules-based framework is crucial for guarantee management

Rules-based frameworks governing the issuance and monitoring of guarantees are strongly recommended. A robust governance framework requires a clear legal framework, a risk-management function, institutions available to perform assigned functions, a team of dedicated personnel, a database and an appropriate disclosure and reporting framework.

Major objectives of rules-based governance frameworks for government guarantees are outlined below.

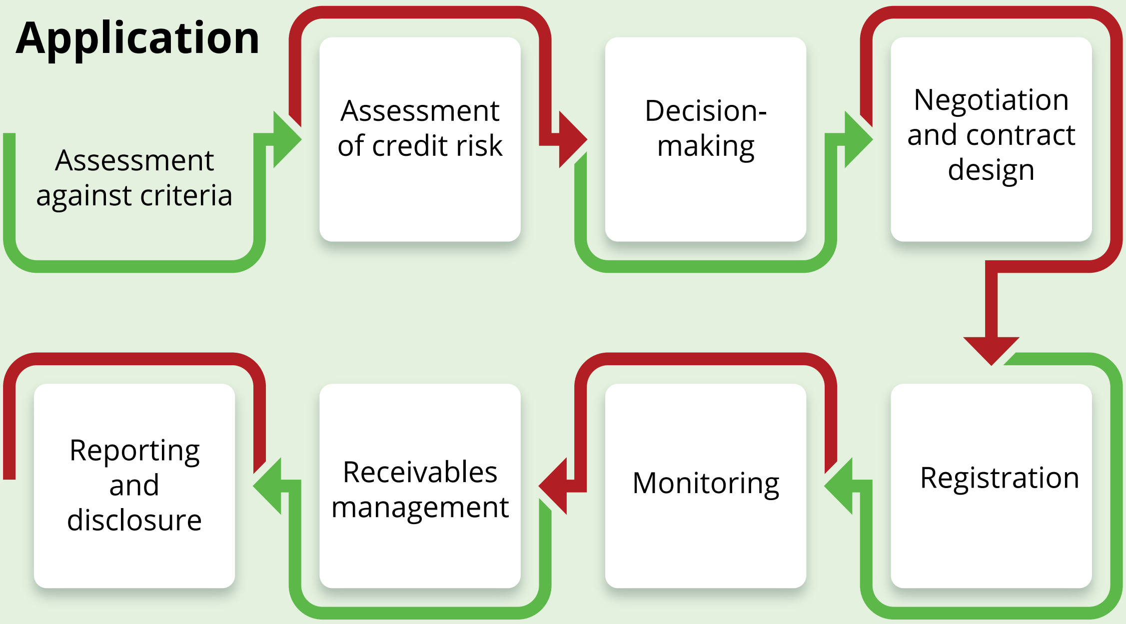
- **To inform decision-makers (authorities) on the costs and risks of the guarantee application**
  - Informed decision-making provides for comparison of the guarantee with other forms of government support, such as on-lending and direct subsidies. To achieve this objective, costs and risks of the guarantee should be assessed ex-ante, before the issuance decision is made, and the decision-making authorities should be well informed of the outcome of these assessments.
- **To mitigate and manage risks arising from the guarantees both at instrument and portfolio level**
  - Following the risk manager's assessment of the project (loan), the applicant's financial performance and its ability to repay should be assessed as well as appropriate risk-mitigation tools developed and implemented, when a government guarantee is issued.
  - Tools used by governments to mitigate the risks are, amongst others, charging an appropriate guarantee fee, requesting collateral from the applicant, limiting the guarantee to a certain portion of the loan (partial guarantee) for risk sharing and capping the exposure to the government by implementing guarantee ceilings.
  - Risk assessments of guarantees should also consider the government's fiscal and liquidity position, in comparison to the total government CL portfolio.
- **To ensure transparency and accountability during the decision-making process**
  - A robust governance framework, which includes legal and institutional arrangements, ensures transparency and accountability. The framework should clearly define the scope of assessing and monitoring the risk and define roles and responsibilities of the stakeholders.
- **Regular interaction by means of collaboration and co-ordination among different stakeholders is required during the issuance and monitoring processes**
  - Explicit mechanisms to be put in place to ensure coordination and collaboration amongst line ministries, SOEs and the Ministry of Finance.

Country cases

Although countries may differ in their decision-making and overall guarantee-management frameworks, the quantitative assessment of a guarantee to obtain political approval remains the same in many countries. Registered participants at the CABRI training programme were provided with cases of guarantee issuance frameworks in countries such as Sweden, Brazil, Iceland and Ghana.

With the aim of encouraging participants to go through their own processes, a questionnaire analysis was conducted, with the defined scope of the issuance and monitoring processes of government loan guarantees. Responses received from seven countries (Burkina Faso, Benin, Côte d'Ivoire, Mali, Morocco, Liberia and South Africa) formed the background of the discussions in Session 2.

Figure 1: Main processes of guarantee management frameworks



Application

The institution responsible for receiving and evaluating the government loan guarantee applications is in most instances the Ministry of Finance/Treasury. A process, where potential beneficiaries (SOEs) apply through their respective line ministries to the Minister of Finance is common practice. The application is usually accompanied by the terms of the proposed guarantee and the underlying loan, project documents/reports, recent financial and operating statements of the applicant, and a cash flow forecast of the project and the entity. In all seven participant countries responding to the questionnaire, the Ministry of Finance receives the applications for government loan guarantees (See Table 1).

Table 1: Institution receiving the applications for government loan guarantees

Benin	South Africa	Liberia	Burkina Faso	Côte d'Ivoire	Mali	Morocco
Ministry of Economy and Finance	Ministry of Finance (National Treasury)	Ministry of Finance and Development Planning	National Committee of Public Debt or Ministry of Economy Finance and Development	Ministry of Economy and Finance	Ministry of Economy and Finance	Ministry of Economy and Finance and the Reform of the Administration

Assessment against criteria

It is a global practice that there are certain pre-set criteria or conditions that apply to government loan guarantees, such as:

- The applicant must be a public sector institution or a publicly owned company (i.e. no loan guarantees are issued for private companies/institutions)
- The applicant must be a legal entity (i.e. no loan guarantees are provided for individuals)
- The project to be financed with the guaranteed loan must be part of the investment plan and/or must be a priority project within the investment plan
- Loan guarantees can be issued only for certain loan types (e.g. concessional loans only)
- The applicant must not have any unpaid arrears with the Ministry of Finance/Treasury
- The applicant must provide collateral or a counter-guarantee
- Other specific conditions for SOEs or sub-national entities
- Solvency requirements for banks and credit providers.

The questionnaire responses received indicated that the loan guarantee applicant must be a legal entity, and that loan guarantees are provided only for those projects approved or identified under the government's development plan. Apart from the case of Benin, no government guarantee will be considered if the applicant still has unpaid arrears with the Ministry of Finance. A counter-guarantee or collateral is required from private entities in countries such as Benin, Burkina Faso and Côte d'Ivoire. (See Table 2).

Table 2: Conditions/criteria set for government loan guarantee applications

	Benin	South Africa	Liberia	Burkina Faso	Côte d'Ivoire	Mali	Morocco
Public entity only		✓	✓		✓	✓	✓
Legal entity only	✓	✓	✓	✓	✓	✓	✓
Only for projects in the investment plan	✓	✓	✓	✓	✓	✓	✓
The applicant must not have any unpaid debt/ arrear to the Ministry		✓	✓	✓	✓	✓	✓
Counter-guarantee or collateral is required	✓			✓	✓		
Project passed the viability assessment of Line Ministry		✓					
Limit applied		✓		✓	✓	✓	

Assessment of credit risk

Assessing the credit risk (ability to pay), requires certain risk-management tools and methodologies within the public debt office's risks management divisions. In the absence of a methodological approach, decision-makers might not be able to assess the risks properly or have a full understanding of the risks the government is facing.

A credit-scoring methodology is used by the Credit Risk Unit within the Asset and Liability Management Division at the National Treasury of South Africa. In the other countries, applications are received and evaluated for their creditworthiness, but no risk assessment methodology is used (see Table 3).

Table 3: Credit risk assessment

	Benin	South Africa	Liberia	Burkina Faso	Côte d'Ivoire	Mali	Morocco
Credit risk assessment with an analytical approach – Methodology applied		✓ Credit scoring					
Credit risk is assessed based on documents provided	✓		✓	✓	✓	✓	✓
Who conducts the credit risk assessment?	National Debt Commission	ALM-Credit Risk Department	Debt Management Unit	NCDP	Public Debt Directorate	The National Treasury and Public Accounting Department (DNTCP)	Ministry of Economy and Finance and the Reform of the Administration (MEFRA)

Decision-making

The decision-making authority for government loan guarantees is the Minister of Finance in most cases, while the cabinet (council of ministers) or a high-level decision-making committee are sometimes given the authority in certain countries. The role of the legislature (Parliament) is to amend/approve the rules by setting limits or amending regulations. A phased approach is followed in most countries, where an application will go through various assessments and recommendation processes before the minister eventually approves or rejects the loan guarantee (see Table 4).

Table 4: Decision-making structures

	Benin	South Africa	Liberia	Burkina Faso	Côte d'Ivoire	Mali	Morocco
Decision-making authority	Council of Ministers	Minister of Economy and Finance	Debt Management Committee	Minister of Finance	Minister of Economy and Finance	Minister of Economy and Finance	Minister of Economy and Finance
Limit-setting authority	Parliament	Parliament	Parliament	Parliament	Parliament	Parliament	Parliament
Approval/ executive power					Council of Ministers		Head of Government
Technical decision	National Debt Commission	Fiscal Liabilities Committee		CNDP	Consultative Committee		Coordinating committee within MEFRA

Negotiation and contract design

Contract terms should be negotiated carefully, preferably by public debt managers/risk managers. This is to ensure that certain safeguards and mitigation strategies are built into the contract design.

These safeguards/considerations, may include collateral and counter-guarantees (if there are any), a guarantee fee and administrative costs charged against the applicant/borrower, rules and procedures for when guarantees are called, financial and information-sharing obligations by both lender and borrower, sanctions for noncompliance, obligations in case of default, the step-in conditions for government, and recovery (collection procedures of the government pay-outs).

Mali and Burkina Faso are among the countries where contract preparation and negotiation are part of the risk-management framework. In developed and some emerging market countries, public debt managers are well equipped to negotiate government loan guarantee contracts, but in developing countries, such expertise may not be readily available.

Registry

Keeping record of reliable and updated data on government loan guarantees enables regular statistical reporting, developing analytical approaches to measuring risks, managing claims from guarantees and monitoring the repayments on loans of the borrowers.

Preferably, guarantees should be recorded through a systemic database and undertaken by institution/department, as defined in the legal framework. In practice, excel-based data recording and standard systems developed by international organizations such as CS-DRMS (Commonwealth) or DMFAS (UNCTAD) are common, while tailor-made information systems are used in countries like South Africa and Morocco. However, countries have realised that further enhancement of their respective recording systems is required (see Table 5).

Table 5: Registration of loan guarantees

	Benin	South Africa	Liberia	Burkina Faso	Côte d'Ivoire	Mali	Morocco
Institution/ department responsible for registry	The Autonomous Amortization Fund	National Treasury/ ALM Division	Debt Management Unity-Ministry of Finance and Development Planning	Public Debt Directorate of the Ministry (MINEFID)	Ministry of Economy and FInance		Debt Management Department
System used for registry	Common-wealth Secretariat Debt Recording and Management System	Excel-based	Excel-based Guaranteed domestic debt-CS-DRMS	DMFAS (starting from this year)	Debt Management and Financial Analysis System	DNTCP and General Directorate of Public Debt	Debt Management System (Wall Street Suit)

Monitoring

Monitoring disbursements (payments) and cash flows of government loan guarantees' performance is conducted relatively well. However, monitoring the financial health and creditworthiness of SOEs throughout the life of the guarantee is more challenging. Expertise in the fields of water, electricity and transportation, for example, is also lacking.

Participating countries indicated that on a semi-annual or annual basis, they do conduct reviews and performance checks on SOEs and other borrowers. Borrowers (SOEs) do provide loan guarantee cash-flow information regularly to the Ministry of Finance (public debt management divisions).

Receivables management

Managing claims in cases of default is an important part of guarantee management. The legal framework should enable the government to monitor and collect any receivables arising from guarantees. This includes unpaid fees, penalties, other expenses, receivables from the payments made for calls on guarantees, and collaterals. Receivables are dealt with by accounting units within the public debt management division (see Table 6).

Table 6: Receivables management

	Benin	South Africa	Burkina Faso	Côte d'Ivoire	Morocco
Legal framework for monitoring and collecting receivables		Captured in guarantee framework agreements	Public debt legal framework and clauses in guarantee contracts		There exists a legislation for receivables management
Institution/ department responsible	Project monitoring Department of the Autonomous Amortization Fund	For guarantee fees ALM monitors collections	MINEFID/Public Debt Directorate (PDD)	Public Debt Directorate	The public accountant is in charge of debt collection, issuing of revenue orders against defaulting beneficiaries
Is data on past payment performance of borrowers available?	Limited number of guarantees issued	Data recapitalization of SOEs for debt servicing available	Yes, with the PDD		Yes, through accountant framework

Reporting and disclosure

Disclosure of information allows decision-makers to make informed decisions, when needed. It also reduces the risk perceptions of lenders and rating agencies. Government loan guarantees are disclosed and reported mainly through debt management reporting, budgetary documents prepared and/or government annual financial statements (see Table 7).

Table 7: Reporting and disclosure

	Benin	South Africa	Burkina Faso	Morocco
Information disclosed on guarantees	The normal amount issued and outstanding amounts are published regularly as part of the monitoring of public companies	Nominal guarantee values, disbursements by the SOEs, general information on portfolio	A report is envisaged this year. Debt statistical bulletin, scheduled for release on March 31, 2021, will include guarantees in the debt data	MEFRA regularly publishes data on guaranteed debt – external and domestic
Form of disclosure	The annual debt management report and a quarterly data statistical bulletin	Budgetary reporting – Annual	Public debt reports, budget reports	Public debt reports, statistical bulletins

In conclusion of this section, it is noted that participating countries are heading in the right direction in developing and implementing proper loan guarantee management frameworks and processes. Legal frameworks on governance, application processes and roles and responsibilities are well established in most countries. However, methodological assessment of credit risk, contract negotiation, managing and collecting claims that originate from guarantees issued, close monitoring of entities and sanctions for non-compliance are still lacking (see Table 8).

Table 8: Strengths and challenges

	Benin	South Africa	Liberia	Burkina Faso	Morocco	Mali
Strengths	• The guarantee application framework with a detailed file justfying the project and good financial situation that guarantees the payment of the debt by the due dates	• Credit risk assessments • The criteria for consideration of applications • Committee structure (Fiscal Liabilities Committee) • Guarantee fee framework	• Legal framework on centralised borrowing mechanism	• The application process • Evaluation against criteria • Decision-making	• Monitoring of publicly guaranteed debt is set at the same level as that of central government debt management • The objective is to have a reliable database for the continuous quantification of public external debt commitments	• Primary legal framework exists
Challenges	• Strict and rigorous guarantee issuance framework which limits guarantee issuance to a minimum	• No recovery mechanism (SOEs are not allowed to default, they are recapitalised when in distress or facing a moral hazard)	• Fee charging • Receivables management • Step-in conditions, rules and procedures to follow when guarantees are called • Sanctions for non-compliance	• Reporting and disclosure • Receivables management • Negotiation and design (preparation) of contracts	• Updating legal framework • A ceiling will have to be defined and authorised by Parliament for the guarantees • Implement credit risk assessment and management tools	• Assessment against criteria • Credit risk assessment • Negotiation and design (preparation) of contracts • Monitoring • Receivables management • Lack of regulation of the whole process

Session 3

How Burkina Faso created an institutional environment for managing guarantee and monitoring processes with a risk-management approach

Burkina Faso provided participants with an insight into how building institutional arrangements brought about co-ordination for collective and informed decision-making, and how an enabling environment for credit risks assessment was established.

The following legislative framework manages government guarantees in Burkina Faso:

- Decree No. 2009-150/PRES/PM/MEF of 27 March 2009 governs guarantees issued by the state
- The Finance Act No. 021-2016/AN, as amended, stipulates that only the Minister of Finance may approve guarantees, set out limits on guarantees issued and provide a legal basis for the guarantees granted under the PPP arrangements
- The OHADA Uniform Law on Security Interests (AUS) allows for domestic and foreign creditors to grant financing for development purposes within OHADA regions in Burkina Faso.

The Decree of 2009 also allows for the establishment of the National Public Debt Committee (CNDP) to recommend government guarantees to the Minister of Finance for approval.

As part of the partnership with the private sector, no pre-financing arrangements are allowed for government guarantee purposes.

In terms of recording and monitoring, loan guarantees are registered using excel spreadsheets; however, this will be replaced by a proper database management system, such as a debt management and financial analysis system (DMFAS) in the future.

Monitoring is conducted by a special unit within the debt management office, and loan guarantees are reported as part of the annual financial statements.

From the discussions it is clear that Burkina Faso has made considerable progress in building the necessary legal and institutional structures for the management of the guarantee application and monitoring processes, but is still lagging in the following respects:

- The assessment of the credit risks of government loan guarantees
- Setting up appropriate accounting standards and practices
- Finding mechanisms to mitigate the risks associated with loan guarantees
- The recording, monitoring and reporting (publishing) of guarantees.

Session 4 took the form of a role-play exercise designed to simulate the guarantee application, credit risk assessment and recommendation for approval processes.

Participants were given a scenario of a fictitious country regarding the application, assessing, monitoring, and approval processes of government loan guarantees. They were requested to discuss, debate and assess the case given, and to report back their findings to the Guarantee Certification Committee for final recommendations to the Minister of Finance.

Project in brief

1. The Minister of Finance is requested to provide a government loan guarantee to the Electricity Utility (EGU), in terms of the Public Finance Management Act (PFMA), which gives effect to the Constitution.
2. The EGU presents its case before the Guarantee Committee for a guarantee to be issued.
3. The Credit Risk Unit assesses the application, considering the risks involved, and then makes a recommendation.
4. The project involves a $5 billion loan for the EGU to 'go green' as part of its strategy to diversify and expand the current generation capacity.
5. The existing generation technology is 'old' and not environmentally friendly. Furthermore, it is expensive to maintain.
6. $2 billion will be financed partially internally and partially by the government.
7. The loan is over a 20-year period with a grace period of 5 years and the total cost of the project is $7 billion. Interest is charged at 7 percent with a front-end fee of 0.25 percent per annum (commission).

Scenario presentation: issues highlighted by the Credit Risk Unit

1. The EGU receives tariffs, set by the regulator, which are not reflective of the cost to the company.
2. The EGU has a social responsibility to deliver services to vulnerable groups in society without receiving proper compensation for such services.
3. The fiscus also does not have 'fiscal space'.
4. The EGU is a monopoly operator in the 'energy' sector.
5. The Credit Risk Unit followed strict guidelines in its assessment –
    - there was a demonstrable need for the government to accept the risk, in line with its overall development strategy.
    - it was not certain that the applicant demonstrated that it could generate sufficient cash flows from the project to meet obligations timeously. The suggestion, therefore, was that conditions should be attached to the guarantee to mitigate against liquidity risk.
    - the guarantee and underlying transaction had to adhere to applicable legislation.
    - it was inconclusive as to whether sufficient evidence had been received to satisfy the requirement that a complete assessment of the underlying project had been undertaken by the appropriate ministry. Some of the 'missing' information should have been provided by the Department of Energy on sector-related matters and by the Department of Public Entities on 'shareholder' and finance-related matters.
    - it was determined that the underlying project was partly of a social nature, in which case the project should be part-funded through the budget.
    - the application complied with the requirement that any entity that had not previously adhered to guarantee conditions should not be provided with a guarantee.

EGU scenario presentation

1. The transaction (loan) was concluded on very favourable terms.
2. There was a huge need to increase its generation capacity and to diversify its current network.
3. The EGU wanted to move out of the 'old' technology into 'green' energy.
4. The project was of a social nature, since many citizens were unable to pay for services.
5. There was a strong case that budgetary support was required.
6. The EGU is currently running at a loss. Various reasons accounted for these losses. The EGU had a social responsibility towards vulnerable members of society, and received inadequate compensation, as a result of end-users not paying for the services. There was also a lack of political support.
7. Political interference ensured that tariffs were kept low and did not reflect inflation or cost. The EGU could not raise sufficient revenue.

The committee's responses and recommendations

1. Both teams had difficulty explaining why no prior relationship had been built between EGU and the lender before entering into a transaction of such magnitude. Line ministries were not playing the role that they should have been playing. As part of the assessment, there ought to have been an input from the sector department.
2. Some input on the cash flows of the entity and its potential impact on the project should have been provided by the Department of Public Entities (DPE).
3. The committee was asked whether the Minister of Public Entities would be amenable to the idea that, should there be cash flow shortfalls, the underperforming cash flows would first be found on the budget of the Minister of Public Entities before approaching the Department of Finance.
4. The credit risk team referred to the $5 billion but was silent on the $2 billion that would be funded jointly by the EGU and the state. There was no clarity in respect of the ratio between the state and EGU on the $2 billion. This was not a 'good sign'.
5. With regard to credit risk, it was expected that a separate request on the $2 billion would be submitted to relevant committees. The credit risk team only assessed the $5 billion guarantee.
6. At this point, the committee was unable to say what the recommendation would be. The minister takes the final decision, but it seemed that more information should be obtained before an informed recommendation could be made to the minister.
7. The committee found that where reference is made to the non-commercial aspects of the business, the social nature of the business should be costed. This would be very helpful and present a strong case that such costs should be funded by the state.

8. Both the credit risk committee and the EGU were asked to give attention to project implementation, especially because of the large size of this project. Reference was made to risks such as 'black swan events' and the 'optimism bias phenomenon', with large public projects referred to as "the Vietnam of policy and management' (i.e. easy to start and very expensive to stop). These issues had not been considered by either of the teams.

9. The committee made the following findings:

    a. The committee was inclined to think that part of the project should be on budget rather than provide a full guarantee that de facto would result in a budgetary injection, even if this entailed increasing the deficit. It would be incorrect to take the approach that, to avoid the deficit from increasing, a guarantee should be provided instead.

    b. Discussions with the treasury officials requesting funding should not conclude that any guarantee not provided actually amounts to a bailout at some point in the future. If a proper budgeting process is followed, relevant provisioning would have to be made to accommodate a risky project. This implies making provision in a contingency fund that would, in any event, result in the deficit increasing. Better that this is done upfront.

    c. A case had been made for some budgetary support. From the information gathered, there was a need for some form of trilateral meeting between the Ministry of Finance, the Ministry of Energy and the DPE – this implies three budgets that can be utilised to establish where resources might be found.

Conclusion

From the discussions above, there appear to be many matters to consider prior to recommending or approving government loan guarantees. Before submitting a loan guarantee application, relevant stakeholders should engage first in order to agree on the best approach or to consider alternatives. Practices where SOEs apply for government guarantees without proper consultation have led to unplanned bailouts or capital injections in the past, which have huge financial implications for the fiscus as a result of higher debt levels. Even during the role-play, without proper consultation and information, the guarantee committee had found it very difficult to make a final recommendation.

Perhaps a more holistic approach is needed, where stakeholders engage earlier in the process, to decide what would be the best option for the SOEs financial difficulties, governance issues and projects undertaken. Stakeholders should not leave their challenges and shortcomings to be addressed by guarantee certification committees. It seems, going forward, that applying for guarantees should only be considered only if all other options have been exhausted.

Thanks were extended for all contributions made during the training session. Following the training session, participants had a much better understanding of the challenges and shortcomings they face, in applying, assessing and approving government loan guarantees. For further support, countries are welcome to approach CABRI on any in-country assistance required.

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