POLICY FRAMEWORK ON GOVERNMENT GUARANTEES

FOR THE

REPUBLIC OF THE GAMBIA

March, 2024

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ABBREVIATIONS

DLDM	Directorate of Loans and Debt Management
DPPP&PE	Directorate of Public-Private Partnerships
SOE	State-Owned Enterprise
MoFEA	Ministry of Finance and Economic Affairs
PE	Public Enterprise
PS	Permanent Secretary
PFA	Public Finance Act
GoTG	Government of The Gambia
MOJ	Ministry of Justice

DEFINITIONS:

"**Public Enterprise**" or "**State-Owned Enterprise**" - means a body corporate or other body or institution, wholly owned or controlled by the Government as defined in section 175 of the Constitution of the Republic of The Gambia, 1994.

"**Commercial State-Owned Enterprise**" – means a body corporate or other body or institution, wholly owned or controlled by the Government, established to carry out commercial activities as defined under the State-Owned Enterprises Act.

"Budget Call Circular" - Document issued by the Ministry of Finance requesting the submission, in a prescribed form, of the revenue and expenditure estimates of MDAs, for the next financial year.

"Deed of Guarantee (DoG)" - Formal documentation of the guarantee arrangement.
Government Business

"Guarantee" - A commitment by the Government to repay the financial liabilities of another entity, should that entity default.

"Guarantor" - The Government of The Gambia, as the entity providing the guarantee.

"Guarantee Beneficiary" - The lender, provider of the loan/credit to be guaranteed.

"Guaranteed Entity" - The entity whose debt the Guarantor is guaranteeing.

"Guarantee call" - The occurrence of a trigger event under the Deed of Guarantee that gives the Guarantee Beneficiary the right to request payments under the loan/credit from the Guarantor.

SECTION 1: INTRODUCTION

1.1. PURPOSE

Over the years, the government has guaranteed the debt of state-owned and private sector entities, to enable the achievement of priority development goals, at reasonable costs and risks. However, failure on the part of these entities to honour their obligations can create significant fiscal and reputation risks to the government's operations.

In keeping with the requirements under section 46 of the Public Finance Act, 2014 ("the PFA"), the Government Guarantee Policy Framework (the "GG Policy Framework") provides coherent guidelines to govern arrangements involving the issuance of government guarantees to entities. By managing the fiscal risks associated with guarantees, these guidelines aim to contribute to the achievement of the government's overarching goal of fiscal and public debt sustainability.

The GG Policy Framework is to be read in conjunction with the relevant governing legislation cited in Section 2.1 of this document.

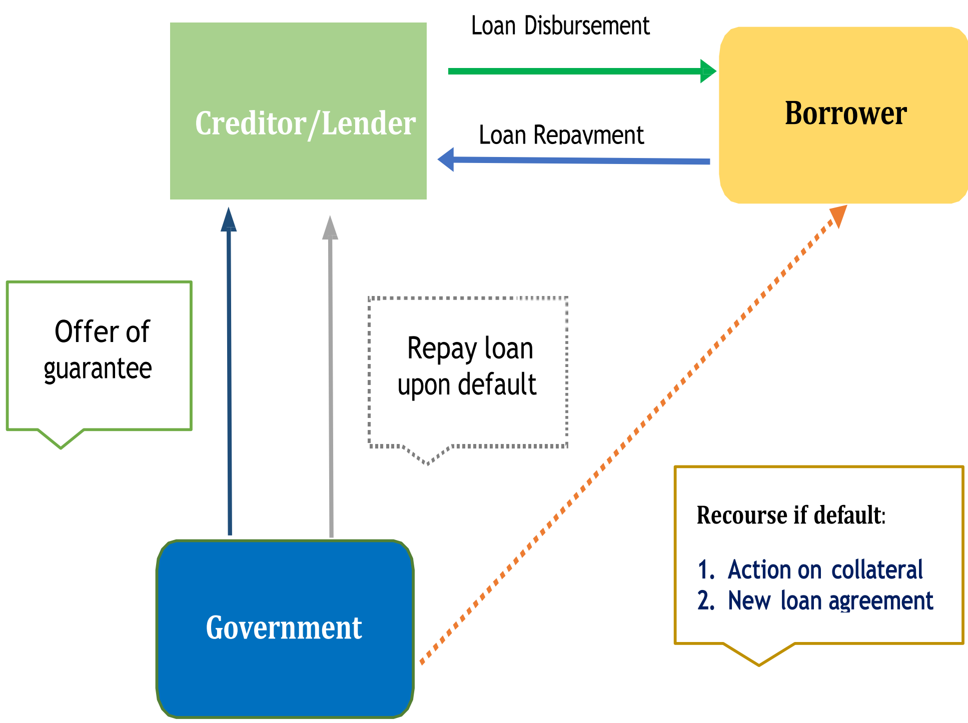
1.2. DEFINITION OF GUARANTEE

A guarantee is an explicit undertaking by the issuer to guarantee the fulfilment of the financial obligation for which the guarantee is issued; for the avoidance of doubt, under no circumstances shall letters of intent, letters of comfort or similar letters, or approval of any borrowing to be undertaken by another entity, be considered a guarantee or any other form of legal undertaking, as defined in the Public Finance Act, 2014.

In line with the activities/roles described above:

- the **Guarantor** is the Government;
- the **Guaranteed Entity** is the borrower (e.g., a public entity) whose financial obligations are covered by the Guarantor;
- the **Guarantee Beneficiary** is the creditor/lending institution (e.g., an investment bank or an international financial institution); and
- the **Deed of Guarantee** ("the DoG") is the legal document executed between the Guarantor, the Guaranteed Entity, and the Guarantee Beneficiary.

Figure 1: Typical Loan Guarantee Flow Diagram



1.3. POLICY OBJECTIVES

The principal objectives of the GG Policy Framework are to:

- operationalize the legal provisions contained in section 46 of the PFA relating to the provision of guarantees by the government;
- provide operational clarity to all stakeholders involved in government guarantee activities;
- ensure judicious evaluation, monitoring and management of costs and risks associated with guarantees on the government's fiscal position;
- uphold the key principles of transparency and accountability in government decision-making related to the issuance of sovereign guarantees; and
- promote 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 GG Policy Framework is to provide evaluation and decision-making guidance for prospective Guarantee Beneficiaries, Guaranteed Entities, the Directorate of Loans and Debt Management ("DLDM") and the Ministry of Finance and Economic Affairs ("MOFEA") regarding requests for sovereign guarantees.

The GG Policy Framework only governs legally binding sovereign guarantees that are provided to cover a Guarantee Beneficiary's unpaid financial obligations that arise from the crystallization of specified trigger events.

The GG Policy Framework shall apply to guarantees provided by the government on loans to Public Enterprises (PEs) and Commercial State-Owned Enterprises (SOEs), as defined in the Public Finance Act, 2014 ("the PFA") and the State-Owned Enterprises Act, 2023 ("the SOE Act") and private domestic companies and foreign entities—the latter two groupings on an exceptional basis, only.

Exclusions to the GG Policy Framework are:

- **Guarantees 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 guarantee programmes governing these activities to assess the creditworthiness of individuals and ensure prudent use of public resources.
- **Guarantees for Foreign Governments**—Decisions will be made upon the recommendation of the Cabinet, with input from the MOFEA,
- **Guarantees for Public Private Partnerships (PPPs)**—Where guarantees are to be issued as part of a risk sharing arrangement, with the objective of improving the viability and sustainability of a project, decisions will be addressed within the context of the government's PPP policy.

1.5. ADMINISTRATION AND REVIEW

The DMO is to:

- administer the GG Policy Framework.
- maintain a comprehensive database to record, manage, monitor and report on all government guarantees and related activities, in accordance with the requirements of the PFA.
- review the GG Policy Framework at least once every five years, to ensure ongoing relevance and alignment with applicable standards and legislation. Reviews should include, inter alia, historical performance/compliance of Guaranteed Entities with respect to their guaranteed facilities and the different types of guarantees provided. However, the DLDM may have cause to modify the GG Policy Framework prior to this timeline—based on the experience gained in implementing the framework.

Any amendments recommended by the Director, DLDM (the “Director”), after consultation with the Permanent Secretary are to be provided to the Minister of Finance (the “Minister”) for Cabinet’s approval. Thereafter, the amended GG Policy Framework is to be published before coming into effect.

SECTION 2: LEGAL AND INSTITUTIONAL FRAMEWORK

2.1. LEGAL FRAMEWORK & REQUIREMENTS

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

- Public Finance Act, 2014 (the “PFA”); and the
- State-Owned Enterprises Act, 2023 (the “SOE Act).

2.2 REASONS FOR ISSUANCE OF GUARANTEES

As outlined in section 46 of the PFA, the Minister has the sole authority to issue state/sovereign guarantee provided that

1) prior to the issuance of any form of state guarantees, MOFEA has assessed the fiscal risk to the State for such guarantee and the result of the. Risk assessment and the method used in that assessment has been presented to in written form to the Minister;
2) the risk assessment contains the proposed level of guarantee fee to cover the credit risk of the state; and
3) unless the Cabinet has determined otherwise, the beneficiary of the guarantee, has paid to the State such guarantee fee as the Minister has determined to cover the risk of the State, and reimburse or pay the State, as the case may be, in such manner as the Minister has directed –
    a) all sums of moneys paid by the State to honour the guarantee;
    b) all expenses incurred by the State in relation to the guarantee and
    c) interest on all sums of moneys paid by the State to honour the guarantee.

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

- To improve flexibility of borrowing options.
- To improve the viability of public sector investment projects that confer significant social and economic benefits.
- To enhance opportunities for the borrower to access lower cost financing that would otherwise be unavailable.
- To fulfil the requirement in cases where a sovereign guarantee is a precondition for semi-concessional loans from bilateral/multilateral agencies and commercial loan facilities to public sector entities.

2.3. ELIGIBILITY CRITERIA

The Minister will only consider applications for sovereign/State guarantees if the proposed investment meets one or more of the following principles:

- Constitutes a part of the government's investment plan.
- Contributes positively to the national development priorities of the government.
- Has positive economic returns.
- Undergoes a rigorous credit risk assessment and scores an acceptable rating (i.e., low to medium)—as outlined in Section 6. Where this rating is not achieved, the government will reserve the right to determine whether to approve or deny an application, based on the project's ability to generate positive financial and economic benefits for the country.

Furthermore, the prospective lender must be an approved financial institution, and the request must fall with the government's limits for outstanding guarantees and not have as adverse impact on the government's debt sustainability indicators.

2.3.1. Entity-specific Eligibility Requirements

a. **Public Enterprises/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 records of default or arrears, the guarantee request may be considered if formal arrangements are in place to settle the arrears and where the underlying project will produce positive financial returns and confer economic and social benefits to the country.

b. Private domestic companies:

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

c. Foreign entities

- Projects expected to deliver a net economic return to The Gambia and would not otherwise be developed by a Public Enterprise (PE), Commercial SOE or domestic private company.
- Have no formal debt arrears.
- Have no tax arrears, including Social Security contributions and government taxes.
- Projects that have commercial characteristics and can generate income by charging market prices to compensate for costs **will not** be considered.

2.4. GOVERNANCE AND INSTITUTIONAL FRAMEWORK

The governance and institutional arrangements for guarantees will typically involve one of more of the following government entities.

- Cabinet
- Ministry of Finance—the Minister and the Permanent Secretary

- Directorate of Loans and Debt Management
- Ministry of Justice
- Accountant General's Department
- Line Ministries
- SOE Commission

2.4.1. Roles and Responsivities

a. Cabinet

Approve, on behalf of the Executive, the policy framework for the granting of government guarantees.

b. Directorate of Loans and Debt Management (DLDM)

- manage the public debt portfolio, including government guarantees, in accordance with the public debt management objectives.
- assess the risks in issuing any guarantees; prepare reports on the method used for each assessment and submit the results to the Financial Secretary for transmission to the Minister.
- facilitate the recovery of any payment, including interest and other costs incurred by government, due to the honouring of outstanding guarantees.
- prepare annual reports on outstanding guarantees.
- keep timely, comprehensive and accurate records of outstanding government guarantees in an appropriate database.
- assist and advise the Minister on matters relating to guarantees.
- review proposals for issuance of guarantees, as may be submitted to it for consideration or for obtaining the approval of the Minister.

c. Director, DMO

The Director is to prepare/amend the policy framework for the issuance of guarantees by the government in consultation with the Permanent Secretary and seek the approval of the cabinet, then proceed to seek the ratification and consent of the Attorney General. Upon the approval of all the organs of the government, the policy framework shall be published.

d. Ministry of Finance and Economic Affairs (MOFEA)

The Minister has the power to issue sovereign guarantees and is required to table, in Parliament, reports relative to guarantees.

The Permanent Secretary is to:

- review risk assessment reports on guarantee proposals submitted to the Minister by the DLDM.
- oversee and monitor guarantees and their aggregate limits, consistent with the fiscal strategy report and the annual budget.
- apply a sanction, as deemed necessary, to a Public Enterprise or Commercial SOE which has issued a guarantee without the appropriate authorization.
- ensure that the annual budget includes plans for issuance of guarantees to public or private entities, together with annexes denoting any limits for issuing guarantees.

e. Ministry of Justice

- Assist with the review of all draft loan documents for which guarantees are requested.
- Draft the Deed of Guarantee, in consultation with MOFEA and other relevant parties.

f. Line Ministries

- Conduct initial reviews of all applications for guarantees from PEs, Commercial SOEs and Private Entities as applicable.
- Assist with the overall monitoring and reporting requirements for guarantees.

g. SOE Commission

- Review and consult with the Minister of Finance and Economic Affairs on documents received by the Commission from a Commercial SOE, containing the details of any guarantees to be issued to such SOE for the next financial year.
- Assist with the overall monitoring and reporting requirements for guarantees.

i. Accountant General's Department

prepare, sign and transmit to the Auditor-General, for auditing, statements of contingent liabilities of the government, including any government guarantees.

SECTION 3: GUARANTEE RISK MITIGATION MEASURES AND CONSIDERATION

3.1. GUARANTEE LIMITS

In line with government policies, the government will impose the following limits.

- The optimal stock of government-guaranteed obligations shall be a percentage of GDP, as stipulated in the annual fiscal strategy framework.
- The maximum limit of guarantees as a percentage of the total underlying loan amount that could be extended to any entity, at each point in time, is to be based on the entity's creditworthiness and the government's shareholding in the entity.
- For a new company/private sector firm, PE or Commercial SOE, which has no historical reference, the financial and economic viability of the investment will be used to assess the entity's eligibility.

3.2. PARTIAL GUARANTEE

To safeguard the government against moral hazard and reduce costs in the event that the risk of a default materializes, the MOFEA may recommend that the government grant a partial guarantee with less than 100 percent coverage of the underlying loan. The MOFEA will utilize the outcome of the risk assessment exercise and particulars of the guarantee application in determining the recommended guarantee coverage.

3.3. GUARANTEE CONDITIONS

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

- The posting of collateral—in the case of non-public sector entities and public sector entities having less than 100% ownership by the government.
- Use of loan proceeds restricted to the investment project only.
- Submission of regular reporting on the investment project, along with audited financials and ad hoc financial reports.
- Restrictions on future borrowings—depending on the outcome of the credit risk assessment exercise.
- Restrictions on the validity of the guarantee, if the borrower’s ownership changes.
- Restrictions on the offering as security any asset/security for the purpose of obtaining any other loan guarantee.
- Execution of a counter guarantee that would convert the guarantee to a loan, where the guarantee is invoked.

3.4. GUARANTEE & ADMINISTRATIVE FEES

3.4.1. <u>Guarantee fees</u>

As a norm, a guarantee fee is a prerequisite for availing of a government/State guarantee and is to cover the administrative cost of processing and monitoring the guarantee and the risk of default on the loan. Formal requests for exemption from the payment of the guarantee fee will only be considered by the Minster, upon analysis of the request.

The annual guarantee fee is charged as a constant percentage of the guaranteed debt outstanding and disbursed every year until the guaranteed loan is paid off. The constant percentage is based on the credit score obtained in the initial credit risk assessment.

Constant Fee determined after credit risk assessment	0.5% of DOD	Scores of between 1 and 1.5
	1.0% of DOD	Scores of greater than 1.5 and 2

3.4.2. <u>Administration fee</u>

The management/administration fee is a one-off fee of 0.25% of the total guaranteed amount—to be charged at the signing of the guaranteed loan facility and is to cover costs relative to its arrangement and monitoring.

3.4.3. Both the Administration and the Guarantee Fee are to be deposited into the Consolidated Fund.

3.5. COLLATERAL

Where applicable, the acceptable collateral for a guarantee 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—including the project assets.

The Minister will exercise powers to realize the collateral in accordance with the terms of the guarantee agreement executed with the Guaranteed Entity.

3.6. DEED OF GUARANTEE

The DLDM will provide the Ministry of Justice (MOJ) with the necessary details to prepare a Deed of Guarantee (DoG). At this stage in the guarantee application process, the prospective Guaranteed Entity can commence activities to finalize the underlying loan agreement.

The DoG, which is to be executed between the Guaranteed Entity, the Guarantee Beneficiary and the government, should clearly state all the procedures related to the issuance of the guarantee. General conditions of the DoG should, inter alia:

- follow a standard format and must be endorsed by the Ministry of Justice
- outline the responsibilities of all parties (i.e., the Guarantor, the Guarantee Beneficiary and the Guaranteed Entity) and the terms and conditions.
- specify whether the guarantee is partial or 100 percent.
- include other conditions necessary and appropriate to reduce the risk of the guarantee being invoked.
- provide for the Ministry of Finance and Economic Affairs to be the receiver, on behalf of the Minister, of any notices or other documents related to the DoG.
- be issued for the period of the guaranteed loan, with the termination or end date of the guarantee clearly outlined in the guarantee letter.
- stipulate any guarantee fee charged.
- specify all reporting requirements of the Guaranteed Entity that would allow the government to monitor, in a timely manner, the risk of the guarantee being called.
- include any other conditions and criteria the government may, at its discretion, deem fit to be included in the DoG.

Adjustments to the terms and conditions of the DoG, to be outlined in a variation agreement, are to be submitted to the Minister for the approval.

SECTION 4: GUIDELINES FOR ISSUING GOVERNMENT GUARANTEES

4.1. INTRODUCTION

The need for a government guarantee by potential borrowers is typically identified during multilateral country assistance strategy meetings, or financing discussions with bilateral/export creditor agency meetings and commercial lenders or during bi-laterals between MOFEA and the PEs or Commercial SOEs.

All requests for government guarantees 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, both public and private entities are expected to submit their requests during the time of the annual **Budget Call Circular** exercise, which usually commences in May each year. However, the government recognizes that there may be exceptions to this timeframe, in which case these requests will be considered on this basis—subject to conformance with the established guarantee limit.

4.2. GUARANTEE APPLICATION PROCEDURES

All applications for government guarantees should be submitted to the MOFEA to the attention of the Permanent Secretary.

- Applications for PEs and Commercial SOEs must be submitted through the Line Ministry, where is expected to confirm, before forwarding to the MOFEA, whether:
    1. the loan for which the guarantee is requested satisfies national priorities—in keeping with the objectives outlined in sections 2.2 and 2.3, above.
    2. all other potential funding opportunities were well examined before selecting the guarantee option.
    3. the prospective loan is within the government's overall guarantee limit.
    4. terms and conditions of the loan appear satisfactory and in accordance with the borrower's governing legislation.

4.2.1. <u>Documentation requirements</u>

To ensure a fully informed assessment, an application is deemed to have been made successfully only where the following documents/information have been submitted.

- Term sheet from the lending institution (specifying loan amount, currency, interest rate, maturity, grace period, other fees and conditions) of the loan to be guaranteed, 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).
- Reason(s) for choosing the specific lending institution.
- Where applicable, board resolution clearly stating the board's decision and reasons for applying for a sovereign guarantee, and agreement to comply with the GG Policy Framework.
- Information on how risks affecting the guarantee would be monitored and mitigated throughout the life of the guarantee, including the role of the parent/responsible ministry.

- Details of all existing loans, overdrafts or any other financial exposure, and the security in place for those commitments.
- Annual Reports and audited financial statements for the past three years, and the pro forma financial statements showing forecasted figures for the current year and the next two years.
- Copy of business license, as applicable.
- A statement of money owed to the government.
- Stand-alone credit rating, where applicable.
- Financial forecasts of the borrower for the duration of the proposed guarantee—to include scenario analysis and assumptions.

The DLDM also 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 recommendation under the various units of the DLDM on whether or not to offer a guarantee.

4.3.1. Specific activities of the Units under the Directorate of Loans and Debt Management

a. **Front Office**

- Ensures the completeness of the application and, where this is not the case, requests 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 guarantees.
- Ensures, in consultation with responsible parties within the MOFEA, that the prospective loan is within debt sustainability considerations.

b**. Middle Office**

Once the application is deemed to be complete, the Director will forward the application to the Middle Officer, which may require applicants to make formal presentations of their requests. The Middle Office will, inter alia;

- undertake the credit risk assessment of the application—based on a credit scoring model (see Annex 1) and produce estimates of the cost and risks of the proposed guarantee.
  Depending on the value and complexity of the underlying investment project, the TC reserves the right to have an independent analysis of the risks associated with accessing the guarantee undertaken, with cost to be borne by the applicant.
- confirm the reasonableness of the financial forecasts provided by the applicants.
- determine how the guarantee would affect the government's portfolio of outstanding guarantees and overall debt levels.
- consider whether the timing and nature of the proposed guarantee borrowing would conflict with the government's own borrowing plan.
- consider and recommend whether conditions should be attached to the proposed guarantee.
- the cost-benefit assessment is based on national priorities outlined in the government's economic and development plans.

- the terms and conditions of the underlying loan are competitive and alternative funding opportunities were appropriately considered.
- 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 guarantee fee is appropriately calculated.
- the request could be considered within the limit established for the overall stock of guarantees.
- Upon completion of its review process, the Middle Office 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 expected loss estimate.
    - ⇒ a recommendation on whether a guarantee 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 guarantee fee and other charges.
    - ⇒ a model will be developed to calculate the premium for credit risk assessment.

4.4. FINAL APPROVAL OF GUARANTEE APPLICATION

The Minister, after considering the recommendations for a guarantee made by the DLDM, may approve or deny the issue of a guarantee and impose other conditions or requirements, as deemed necessary in the national interest. The Minister's final decision will be communicated to the DLDM via the Permanent Secretary.

4.5.NOTIFICATION OF DECISION(S) TO APPLICANTS

The Permanent Secretary will communicate, in writing, the Minister's decision on the guarantee application.

- For a PE, Commercial SOEs or LGA decisions will be forwarded directly to the Line Ministry with a copy to the relevant entity.
- For all other entities, the decision will be forwarded to the requesting entity.

SECTION 5: RECORDING, MONITORING AND REPORTING OF GUARANTEES

5.1. RECORDING, MONITORING AND REPORTING

All guarantees 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 achieved through the collective activities of the various entities involved in the guarantee process.

a. DLDM/Ministry of Finance:

The Back Office unit under the DLDM shall be responsible for the following:

- Record the qualitative descriptions and quantitative information (actual and forecast) of the guaranteed loan in the Commonwealth Secretariat Meridian debt recording and analysis programme ("Meridian").
- Ensure that electronic versions of all executed loan/guarantee documents are securely stored in Meridian.
- Monitor the progress on loan payment transactions (i.e., principal, interest and any fees) in a prompt manner and detect any sign of payment difficulties, well in advance.
- Ensure that the annual guarantee fee is collected by issuing invoices for payment on the anniversary of the agreement being executed.
- Prepare annual reports on guarantees (any guarantee given, and called, any payments on guarantees and an assessment of the risk of a guarantee being invoked and the estimated cost of honoring the guarantee) for the Minister to present to the National Assembly no later than end March as provided for in section 52 of the Public Finance Act, 2014.
- Publish information on guarantees as part of the government's quarterly Public Debt Statistical Bulletins and annual financial statements.
- In the case of default, the MOFEA should decide what recourse action should be taken.

FIGURE 2: DLDM's Responsibilities for Loan Guarantee Management

FRONT OFFICE	MIDDLE OFFICE	BACK OFFICE
• Receiving Applications	• Conduct credit risk assessment for applications	• Recoding guarantees
• Assessing applications against pre-set criteria	• Conducting credit risk assessment for the portfolio of loan guarantees	• Monitoring loan disbursements
• Presenting Application to the Middle Office through the Director, for risk assessment	• Estimating guarantee fee	• Monitoring repayments
• Drafting guarantee letters		• Advising on payments for guarantee calls

• Evaluating loans for which guarantees are requested		• Reconciling and sharing of guarantee data
		• Reporting and disclosure

b. <u>Guarantee beneficiaries</u>

- Provide to the Guarantor, via the DLDM, the status of the loan disbursements, repayment schedules and actuals, and any other foreseen event, on a quarterly basis. The Guarantee Beneficiary must also notify the DLDM immediately of any developments that significantly increase the risk of default.

c. <u>Guaranteed entities</u>

- Submit copies of the annual report and audited financial statements to the DLDM during the entire duration of guarantees
- Provide relevant information on the use of funds, disbursements, accounting and degree of implementation of the project funded by the guarantee and conduct regular consultations with the DLDM.
- Ensure that all guarantees are reviewed annually, and copies of reviews forwarded to the DLDM, via the Line Ministry by July 31.

d. <u>Line Ministry/SOE Commission</u>

- Monitor whether the Guaranteed Entity is discharging debt service obligations as per the terms of the loan agreement, whether the repayment capacity for the loan and guarantee amount is impaired in any manner and whether covenants and conditions are being upheld. Copies of these reviews should be forwarded to the DLDM annually, by July 31.

SECTION 6: CALL OF GUARANTEE

6.1. EVENTS OF DEFAULT

In the event of default by the borrower, the Guarantee Beneficiary may invoke the guarantee.

- As a first step, the Guaranteed Entity should inform any case of impending/likely invocation, well in advance, to the DLDM, along with a corrective time limit—and not to exceed sixty days from the date of default.
- Upon receipt of the report from the Guaranteed Entity, the Director shall refer the document to the DLDM-Back Office to verify whether the default in question is covered by the guarantee and whether the claim is validly made in terms of the guarantee.
- Simultaneously, the Director will write to the Guaranteed Entity demanding immediate payment of the amount due to the Guarantee Beneficiary, seek an explanation of the default and outline measures (e.g., realization of the collateral) that will apply should the default not be rectified. Both the Minister and the Cabinet will be made aware of the default situation.
- Where recommended by the DLDM-Back Office, the government will honor the guarantee and make payment to the lender from the Consolidated Fund—without need for any appropriation.
- Any amount paid by the government as a result of the guarantee being called will become a loan between the government and the Guaranteed Entity, and fall under the government's Policy Framework for Lending. Where this is the case, the MOFEA, with the assistance of the Ministry of Justice, will prepare a loan agreement for execution between the parties, and the performance of the agreement will be monitored by the MOFEA, with regular reporting in the government's fiscal accounts.
- The Director will prepare a report for the Minister, for presentation to Cabinet, on all guarantee calls—providing details on payments made by the government and an estimate of the associated cost.

SECTION 7: CREDIT RISK ASSESSMENT AND EXPECTED LOSS

7.1. CREDIT RISK ASSESSMENT

Credit risk assessments help to evaluate the creditworthiness of the prospective Guaranteed Entity, in terms of repayment of the guaranteed 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 categorized under 'regulatory environment', 'sector risk and competitive position and, 'governance and management'.
- Risk range can vary from low risk (1) to `distress' (5).

7.2. WEIGHTING AND AVERAGE WEIGHTED SCORE

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

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.

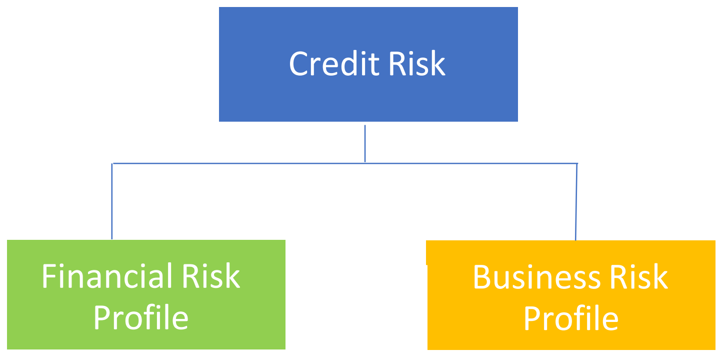
7.4. EXPECTED LOSS

- 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:

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



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

(i) identify the business and financial risk indicators;

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

(iii) assign scores to each risk indicators, based on the entity's performance;

(iv) calculate the weighted score of each risk indicator; and

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

As a starting point, the methodology begins with selected business and financial risk indicators which would be increased over time as the assessment process matures. Selection of business and financial risk indicators will depend upon the sector/area of operation of the prospective Guaranteed 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 <u>Business risk factors</u>

The Business Risk Profile of a Guaranteed Entity is determined based on an assessment of a combination of factors (e.g., the regulatory environment, sector risk and competitive position, and governance and management) as outlined in ***Table 1.***

Table 1: Business Risk Factors and Assessment Considerations

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

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	EBIDTA divided by the sum of short-term debt, long-term debt and financial leases
Debt Structure	*Currency risk*	
	Interest rate risk	Exposure to these three risks
	Re-financing risk	
Performance in meeting financial obligations to government	*Timeliness in Meeting Repayments due*	In Distress or Not in Distress

1.1.2 **Financial risk factors**

The Financial Risk Profile assessment of the Guaranteed Entities 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 factors (i.e., Liquidity, Profitability and Solvency) are measured quantitatively, while the remaining two (i.e., Debt structure and Performance in Meeting Government Obligations) are qualitative measures (see **Table 2**).

1.2. INFORMATION REQUIREMENTS

Potential Guaranteed 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 project loan for which a guarantee 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 is used in assessing credit worthiness of an entity and to make a decision on whether or not to offer a guarantee.

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 the 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.

To illustrate, assume the World Bank's Guidance Note ratios for business risk and financial risk of 45%: 55%, respectively, 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 GUARANTEE OFFER

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

Low Probability of default	**Moderate Probability of Default**	**High Probability of Default**
`Offer Guarantee’	`Re-assess Credit Risk and Re-consider’	‘Do not offer Guarantee’
1 ⟷ 2	2 ⟷ 3	3 ⟷ 5

The above example with the overall weighted score of 1.55 falls under the category of `Offer Guarantee’.

1.5.RISK QUANTIFICATION – PROBABILITY OF DEFAULT

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 & Poor’s (S&P), Moody’s Investor Service (Moody’s), and Fitch) etc.

- Where the country does not regularly carry out international rating exercises, statistical methods or domestic rating could be used.
- For countries that regularly carry out international rating agency exercises, the overall

weighted score is to be converted into an equivalent rating grade and the applicable probability of default for that rating grade is to be applied, as shown in the following example.

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

Table 4: Estimating PDs Using S& P Credit Ratings

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

1.6.EXPECTED LOSSES

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

1.6.1. Expected loss given default

Expected Loss (EL) is determined by the following equation:

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

Where:

Total Exposure = Guaranteed Loan Outstanding

Probability of Default = a numerical probability value between 0 and 1

Recovery Rate = Percentage of amount that can be recovered of the total expected loss

1.6.2. Annual risk status

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

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

1.7.PROJECT RELATED FINANICAL FORECASTS

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

>>THE END<<