GOVERNMENT OF MALAWI

MINISTRY OF FINANCE AND ECONOMIC AFFAIRS

GUIDELINES FOR GUARANTEES, ON-LENDING AND BORROWING BY PUBLIC BODIES

2024

APRIL

Preface

Government of Malawi has prepared these Guidelines for Guarantees, On-Lending and Borrowing by Public Bodies to improve the management of fiscal risks emanating from guarantees, on-lending and direct borrowing by public bodies.

Public bodies play a key role in delivering projects which are beneficial to Malawi and to do so they often have recourse to borrowing. In some cases, they may borrow directly and in others guarantees and on-lending enable them to secure financing where it would not otherwise be available or on more favourable terms. These facilities, therefore, serve as important tools for Government. They also, however, present risks to Government. In the circumstance that a public body defaults on its loan, Government may have to assume the liability and repay the obligation out of public money. This will have a negative impact on the fiscal position that is especially problematic due to its unpredictable and immediate fashion.

Given the risks these facilities pose to Government, they must be utilised in a prudent manner. They must only be extended when necessary and when other options have been exhausted. Furthermore, the institutions benefiting from such facilities must demonstrate their capacity to repay any loans that they contract. These Guidelines help to ensure these conditions will be met. They do this by presenting risk mitigation measures that target the aggregate risks posed to Government and the risks posed by individual facilities. They also set out how applications for these facilities will be assessed in a robust manner. As well as improving the process of granting such facilities, these Guidelines are intended to give guidance to the different parties involved in these activities to ensure judicious and expedient evaluation and approval of applications.

These Guidelines were drafted with the assistance of the World Bank and in consultation with stakeholders across Government. The guidelines shall be reviewed as required.

Betchani Tchereni
SECRETARY TO THE TREASURY

Contents

Abbreviations

DAD	Debt and Aid Management Division
DGLAT	Debt Guarantees and Loans Assessment Tool
DMTC	Debt Management Technical Committee
MoFEA	Ministry of Finance and Economic Affairs
PSIP	Public Sector Investment Programme
PFMSD	Public Finance Management Systems Division
RBM	Reserve Bank of Malawi
SOE	State-Owned Enterprise

Definitions

1. "**Guarantee**" is a commitment by the government to repay the financial liabilities of another entity should that entity default.

2. "**Guarantor**" means the Government of the Republic of Malawi, a state-owned enterprise or statutory body, depending on who is providing the guarantee, as per the Public Finance Management Act, 2022.

3. **"Guarantee Beneficiary"** is the provider of a guaranteed loan.

4. **"Guaranteed Entity"** is the entity whose debt the Guarantor is guaranteeing.

5. **"Guarantee call"** is the occurrence of a trigger event under the Guarantee that gives the Guarantee Beneficiary the right to request payments under the loan from the Guarantor.

6. **"Guarantee"** is the legal document executed between the Guarantor, the Guaranteed Entity and the Guaranteed Beneficiary.

7. "**Contingent liability**" means a potential financial obligation that may or may not occur depending on the outcome of a future event usually outside the control of an entity.

8. "**On-lending**" occurs when funds are borrowed by Government with the aim of lending the funds to other public institutions.

9. **"Bank overdraft"** is a short-term facility provided by a financial institution to allow an entity to draw funds even if the entity's operating account has no funds in it. It is a financial claim that requires payment(s) of interest and/or principal on demand.

10. **"Indemnity"** is a legally binding promise whereby a party accepts to undertake a risk of loss or damage that another party may suffer.

11. **"Letter of Comfort"** is a morally, but not legally, binding assurance provided by one party to the other party indicating willingness to meet a payment obligation.

12. **"Letter of Consent"** is a written authority providing permission to an entity.

13. **"Minister"** refers to the Minister responsible for Finance.

14. "**Public body**" means any organ or agency of the Government and includes a local authority, statutory body, state-owned enterprise and such other body as may be defined as such by law.

15. **“Public debt”** means all financial liabilities created as a result of borrowing by the public sector, including called contingent liabilities and all outstanding liabilities created by the issuance of public securities.

16. **“Public interest”** means something that is to the advantage, directly or indirectly, of the people of Malawi.

17. **“State-owned enterprise”** means a body corporation, or subsidiary of a corporation, where the Government, directly or indirectly:

    a. has controlling interest or power;
    b. controls the composition of the board of directors;
    c. has more than fifty per cent of the voting power; or
    d. holds more than fifty percent of any of the issued share capital either directly or through another agency or statutory body.

18. **“Statutory body”** means:

    a. a body of persons, whether corporate or unincorporated, other than the Reserve Bank of Malawi, established by any written law; and
    b. a local authority established under the Local Government Act.

1 Introduction

1. These Guidelines for Guarantees, On-Lending and Borrowing by Public Bodies[1] ("the Guidelines") pertain to (i) the issuance and management of guarantees by Government, (ii) on-lending by Government, (iii) direct borrowing by state-owned enterprises (SOEs) and statutory bodies and (iv) the issuance of guarantees by SOEs and statutory bodies.

2. The Guidelines are underpinned by the Public Finance Management Act, 2022 which provides a legal framework for managing public resources consistent with economic and financial principles with the aim of ensuring effective, transparent and responsible public financial management.

1.A Objectives

3. The objectives of the Guidelines are to:

    a. operationalise the legal provisions contained in Sections 76, 81, 82, 96 and 97 of the Public Finance Management Act, 2022 and Regulations 4 and 7 of the Public Finance Management (Debt and Aid Management) Regulations, 2023;

    b. provide operational clarity to all parties involved;

    c. ensure judicious evaluation, monitoring and management of costs and risks posed to the fiscal position of Government;

    d. uphold the key principles of transparency and accountability in Government decision making; and

    e. promote effective and efficient use and management of public resources.

1.B Purpose

4. The purpose of the Guidelines is to provide guidance for prospective guarantee and on-lending beneficiaries, guaranteed entities, creditors and the Ministry of Finance and Economic Affairs (MoFEA). In addition, the Guidelines provide guidance for prospective direct borrowing and guarantees issued by SOEs and statutory bodies which by law requires approval of the Minister of Finance ("the Minister").

[1] These Guidelines supersede the 2017 Guidelines for the Issuance of Parastatal Guarantees, Indemnities, and Letters of Consent and Comfort.

1.C Administration and Review

5. The MoFEA will administer the Guidelines and review them at least once every five years to ensure ongoing relevance and alignment with applicable standards and legislation. The reviews will consider a range of information including historical performance and compliance of guaranteed entities with respect to their guaranteed facilities.

6. Specifically, the Debt and Aid Management Division (DAD) will administer the Guidelines and record, monitor and report on all Government guarantees, on-lending and direct borrowing and guarantees by SOEs and statutory bodies.

7. The Debt Management Technical Committee (DMTC) will recommend amendments to the Secretary to the Treasury for consideration and approval by the Minister.

2 Legislative and Institutional Framework

2.A Legislative Framework

8. The legislative framework for the issuance and management of guarantees by Government, on-lending by Government, direct borrowing by SOEs and statutory bodies and the issuance of guarantees by SOEs and statutory bodies is based on:

   a. the Public Finance Management Act, 2022; and

   b. the Public Finance Management (Debt and Aid Management) Regulations, 2023.

9. The following sections of the Public Finance Management Act, 2022 are relevant to the activities covered in the Guidelines:

   a. Section 76(1) permits the Minister to on-lend to other bodies, including SOEs or statutory bodies, under a subsidiary loan agreement, such amounts of money obtained through a loan.

   b. Section 76(2) requires the Minister to submit periodic reports to the National Assembly on the status of subsidiary loans.

   c. Section 82(1) gives power to the Minister, where he determines it to be in the public interest or necessary, to issue guarantees to any person, body corporate, organisation, or statutory body on behalf of the Government.

   d. Section 82(2) requires the Minister, within seven days of giving a guarantee, to submit a report to the National Assembly outlining why it was in the public interest and necessary to grant the guarantee and providing an assessment of the risks associated with the guarantee.

   e. Section 96(1) permits a SOE or statutory body, with prior written approval of the Minister, to borrow money by way of loan or overdraft on such terms as agreed between the SOE or statutory body and the lender.

   f. Section 97(1) allows a SOE or statutory body to give a guarantee to its subsidiary if approved in writing by the Minister.

10. The Public Finance Management (Debt and Aid Management) Regulations, 2023 operationalise the provisions of the Public Finance Management Act, 2022 pertaining to the management of debt and aid. The following sections of the Regulations are relevant to the activities covered by the Guidelines:

a. Regulation 4 mandates the Secretary to the Treasury, prior to executing a subsidiary loan agreement for on-lending, to:

   i. carry out a due diligence of the intended recipient of the subsidiary loan;

   ii. negotiate the terms and conditions of the subsidiary loan agreements; and

   iii. prepare a term sheet setting out the on-lending details which shall, together with the signed subsidiary loan agreement, be recorded in the debt recording and management system.

b. Regulation 7 sets out how to apply for a guarantee, including what should accompany an application, and how the Secretary to the Treasury shall assess an application.

2.B Reason for Offering Guarantees and On-Lending

11. As outlined in Section 82 of the Public Finance Management Act, 2022, before issuing a guarantee, the Minister must be satisfied that it is in the public interest and necessary. Furthermore, the Minister must be satisfied that the guarantee is consistent with Section 25 of the Public Finance Management Act, 2022 which outlines the principles of responsible fiscal management.

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

    a. To increase flexibility of borrowing options.

    b. To support priority projects that may not be directly funded by Government.

    c. To improve the viability of public sector investment projects that offer significant social and economic benefits.

    d. To enhance opportunities for the borrower to access lower cost financing than would otherwise be available without a guarantee.

    e. To fulfil the requirement in cases where a sovereign guarantee is a precondition for semi-concessional loans from bilateral or multilateral agencies and commercial loan facilities to public sector entities.

13. Government will on-lend loan proceeds to third parties for the purpose of achieving the following objectives:

    a. To fulfil the requirement in cases where on-lending is a precondition for concessional or semi-concessional loans from bilateral or multilateral agencies to public sector entities.

b. To allow for the provision of goods and services at an affordable price where it would not be financially possible for SOEs or statutory bodies to provide them at such prices.

2.C Eligibility Criteria and Restrictions for Guarantees and On-Lending

14. Proposed guaranteed entities and beneficiaries of on-lent loans must have audited accounts and demonstrate that they will have the operational and financial capacity to service loans.

15. Requests for guarantees or on-lent loans must be consistent with any debt limits Government is subject to and with the principles of prudent fiscal management and sustainable debt management.

16. Government guarantees for proposed investment loans and on-lending must:

    a. serve the public interest and maximise social and economic benefits;

    b. contribute positively to the development priorities of Government; and

    c. improve the financial viability of the project.

2.D Eligibility Criteria and Restrictions for Direct Borrowing, Letters of Comfort and Consent Letters

17. In accordance with Section 96(1) of the Public Finance Management Act, 2022, SOEs and statutory bodies may directly borrow with prior written approval of the Minister.

18. As outlined in Section 96(2) of the Public Finance Management Act, 2022, no liability shall be attached to Government as a result of such approval, unless otherwise approved by Cabinet.

19. Approval of direct borrowing by SOEs and statutory bodies shall be communicated in the form of Letters of Comfort or Consent Letters. Unless otherwise approved by Cabinet, the letters will stipulate that no liability is attached to Government.

20. Letters of Comfort or Consent Letters will only be granted after an assessment of the financial position of an entity.

2.E Eligibility Criteria and Restrictions for guarantees by SOEs and Statutory Bodies

21. In accordance with Section 97 of the Public Finance Management Act, 2022, SOEs and statutory bodies may issue guarantees to their subsidiaries after getting approval from the Minister, but no liability is attached to Government by virtue of the approval.

2.F Eligibility Criteria and Restrictions for Lenders and Intermediaries

22. The prospective lender or any other intermediary must be a credible financial institution with a proven track record in providing financing.

23. The prospective lender will be subjected to due diligence by the Financial Intelligence Authority and Reserve Bank of Malawi (RBM). If the entity is not an official multilateral or bilateral organisation, it should provide evidence of its business licence to conduct such transactions.

2.G Governance and Institutional Framework

24. The following entities are involved in the Guidelines:

    a. Cabinet

    b. Parliament

    c. Ministry of Finance (Minister of Finance, Secretary to the Treasury, DAD, PFMSD, Debt Management Technical Committee (DMTC), Development Division, Accountant General’s Department)

    d. Ministry of Justice

    e. Line Ministries

    f. Borrower

25. **Cabinet**

    a. The role of Cabinet is to evaluate and approve guarantees at the highest level.

    b. The President assents the bill for the main loan agreement which forms the basis for subsidiary loan agreements.

26. **Parliament**

a. Parliament has an oversight responsibility in terms of making sure that accurate reports on new guarantees, existing guarantees and called guarantees are submitted on time.

b. Parliament approves loan authorisation bills for the main loan agreement which forms the basis for subsidiary loan agreements.

27. **Minister of Finance**

a. The Minister is responsible for making the final decision on Government guarantees, on-lending and direct borrowing and guarantees by SOEs and statutory bodies.

b. The Minister is also responsible for presenting to Cabinet the proposal to issue a guarantee.

c. The Minister is mandated to sign the Guarantee after Cabinet’s approval and to submit the required reports to Parliament.

28. **Secretary to the Treasury**

a. The Secretary to the Treasury will receive all applications for Government guarantees, on-lending and direct borrowing and guarantees by SOEs and statutory bodies on behalf of the MoFEA.

b. The Secretary to the Treasury will recommend to the Minister the assessment decision and submit the cabinet paper for approval.

c. The Secretary to the Treasury will sign on behalf of Government the subsidiary loan agreement between MoFEA and the SOE or statutory body.

29. **Debt and Aid Management Division**

a. The Resource Mobilisation Section of DAD will be responsible for receiving guarantee applications from the Secretary to the Treasury and ensuring they satisfy the pre-set criteria, drafting subsidiary loan agreements and guarantees and evaluating prospective on-lent and guaranteed loans.

b. The Debt and Aid Planning section will be responsible for assessing credit risk and calculating fees.

c. The Disbursement and Debt Servicing section will be responsible for maintaining records on all activities covered by the Guidelines. They will also be responsible for monitoring debt servicing for guaranteed and on-lent loans, advising on default and remedial action, preparing reports on guarantees and ensuring fees are paid on time.

30. **Public Finance Management Systems Division**

a. PFMSD is responsible for:

i. analysing financial statements and performance of SOEs and statutory bodies; and

ii. assessing requests for Consent Letters or Letters of Comfort from SOEs and statutory bodies.

31. **Debt Management Technical Committee**

a. A technical committee, led by the Director of DAD, comprised of:

i. Director of DAD – Head of the Committee

ii. Debt Officers from Debt and Aid Planning Section of DAD

iii. Staff from PFMSD

iv. Staff from Development Division of the Department for Economic Planning

v. Subject matter specialist when deemed necessary

b. The Committee is responsible for:

i. carrying out credit risk assessments;

ii. recommending the limits on guarantees and on-lending to the Secretary to the Treasury;

iii. reviewing all ongoing guarantees and their risk status every six months;

iv. monitoring performance against existing limits for guarantees, on-lending and direct borrowing;

v. recommending the granting of a partial guarantee with less than one hundred percent coverage of the underlying loan;

vi. recommending a deductible amount to decrease the amount that needs to be paid by Government in the event of a default; and

vii. recommending approval of lower overdraft amounts than applied for by an institution.

32. **Development Division**

a. For development projects, the Development Division of the Department of Economic Planning will be responsible for ensuring that applications for guarantees and on-lent loans are in line with Malawi's development objectives and, if the application is from an SOE or statutory body, that the projects are in the Public Sector Investment Programme (PSIP).

b. All applications for guarantees and on-lent loans for development projects from SOEs and statutory bodies should be appraised by PSIP unless special waivers are provided.

33. **Accountant General's Department**

a. The Accountant General's Department is responsible for:

i. ensuring that the stipulated fees (administrative fees) are paid into the Consolidated Revenue Fund; and

ii. if default occurs, paying the Lender as per the guarantee requirements.

34. **Ministry of Justice**

a. The Attorney General of the Ministry of Justice will be responsible for the following:

i. Ensuring the loan agreement for which a guarantee is requested or subsidiary loan agreement is legally acceptable.

ii. Vetting the Guarantee or subsidiary loan agreement.

iii. Preparing a legal opinion on the Guarantee or subsidiary loan agreement.

35. **Line Ministries**

a. When an application for a guarantee or on-lent loan is made by an SOE or statutory body, the parent line ministry is responsible for sending the guarantee application to the MoFEA for approval. Before sending the application, it must check that:

i. the project for which the loan guarantee is being requested is in the list of development priorities;

ii. all other alternative financing possibilities have been explored;

iii. the project feasibility report has been prepared and attached; and

iv. the required financial statements are attached.

36. **Borrower**

a. The borrower provides the following documents in support of a guarantee application:

i. Board resolution approving the intention to seek a loan guaranteed by Government.

ii. Detailed project proposal replete with its objectives and justification for the involvement of Government.

iii. Term sheet setting out the terms and conditions of the loan including the proposed repayment schedule and liquidation model.

iv. Audited financial statements for the immediate past five financial years or, if the entity is newly established, all years since establishment.

v. Letters from at least two immediate previous creditors of the applicant stating the performance of the applicant from the date of borrowing to that of full repayment.

3 Risk Mitigation Measures

3.A Limits on Guarantees and On-Lent Loans

37. In line with Section 25 of the Public Finance Management Act, 2022 and Regulations 4 and 7(3) of the Public Finance Management (Debt and Aid Management) Regulations, 2023, and to minimise risk exposure, Government will annually set a limit on the stock of outstanding guarantees and the stock of on-lent loans. The DMTC will recommend values for the limits, through the Secretary to the Treasury, to the Minister who will make the final decision. The DMTC's recommendation will be guided by the Debt Sustainability Analysis. The limits may be adjusted only in cases of exceptional circumstances with prior approval from Cabinet.

38. The limits will be set on the following:

    a. Stock of Government guaranteed debt as a percentage of GDP.

    b. Stock of on-lent loans as a percentage of GDP.

3.B Guarantees by SOEs and Statutory Bodies

39. In line with Section 97 of the Public Finance Management Act, 2022, SOEs and statutory bodies may issue guarantees to their subsidiaries. An SOE or statutory body can only enter such a commitment after providing evidence that it has registered dividends for three consecutive years and that its balance sheet could absorb the guarantee if called. The SOE or statutory body must furnish the MOFEA with financial records to demonstrate its capability.

3.C Partial Guarantee and Deductibles

40. As a means of risk sharing, Government will, in some instances, issue partial guarantees or deductibles.

41. The DMTC may recommend to the Minister any of the following:

    a. The granting of a partial guarantee with less than one hundred percent coverage of the underlying loan based on the results of the credit risk assessment and particulars of the application.

    b. A deductible which will decrease the amount that needs to be paid by the government in the event that a guarantee is called.

c. For overdraft applications, approval of lower amounts than applied for by an institution.

d. That guarantees exclude any penalties incurred by guaranteed entities.

3.D Conditions for Loan Guarantees and On-lending

42. Guaranteed entities and on-lending beneficiaries will undertake to:

a. use loan proceeds solely for the purpose stated in the application for the guarantee or subsidiary loan agreement; and

b. provide Government with periodic reports, audited financial statements and, when requested, ad hoc financial reports.

3.E Additional Conditions for Guarantees

43. Issuance of subsequent guarantees to an entity will depend on the performance of previous guarantees and will depend on the outcome of the credit risk assessment exercise.

44. In the event that the loan proceeds are aimed at supporting operations of an institution or the proceeds are for refinancing purposes, the applicant has to demonstrate through a turnaround strategy that the bridge finance will indeed stimulate the performance of the institution.

45. The validity of the guarantee shall be restricted to the beneficiary and will cease to be in full force and effect if the beneficiary's ownership changes.

3.F Additional Conditions for On-lending

46. Subsidiary loan agreements shall be negotiated with the beneficiary and in line with the Creditors' terms and conditions.

47. The beneficiary shall open an escrow account for the purpose of debt servicing.

3.G Fees

48. For any issued guarantee, guaranteed entities will pay an administration fee of a quarter of a percent.

3.H Waiver of Fees

49. Administration fees may be waived on condition that the beneficiary institution will be involved in quasi-fiscal activities and in line with Section 25 of the Public Finance Management Act, 2022.

4 Procedures and Guidelines for Issuance of Guarantees, On-lending and Other Requests

4.A Application Procedures

50. All applications for Government guarantees, on-lending, Letters of Comfort, Consent Letters and guarantees by SOEs and statutory bodies should be made in writing to the Secretary to the Treasury. In line with PFM Act Section 93, applications by SOEs and statutory bodies for the following financial year should be made when submitting the performance management plans and budgets and this is to be done within three months before the end of the financial year.

51. Applications from SOEs and statutory bodies must be submitted through their Parent Ministry, which is expected to confirm, before forwarding the application to the Secretary to the Treasury, whether:

    a. the loan or borrowing for which the request is made satisfies the objectives outlined in Sections 2.B and 2.C above;

    b. all other potential funding opportunities were well examined; and

    c. the terms and conditions of the loan or borrowing appear satisfactory and in accordance with the borrower's governing legislation.

4.B Documentation Requirements

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

    a. Board resolution approving the intention to borrow or seek an on-lent or guaranteed loan.

    b. Detailed project proposal replete with objectives and, in the case of guarantees and on-lending, justification for the involvement of Government.

    c. Term sheet setting out the terms and conditions of the borrowing or loan including the proposed repayment schedule and liquidation model.

    d. Audited financial statements for the immediate past five financial years or, if the entity is newly established, all years since establishment.

4.C Evaluation and Assessment for Guarantees

53. The Secretary to the Treasury will forward applications for guarantees to the Director for DAD for appropriate assessment and recommendation on whether to grant them.

54. The Director for DAD will convene the DMTC and, as part of its assessment, the specific activities undertaken by the DMTC will include:

    a. Ensuring the completeness of applications and, if incomplete, requesting missing information from prospective borrowers.

    b. Ensuring applications are:

        i. compliant with the eligibility requirements;

        ii. can be granted without breaching any of the established limits; and

        iii. consistent with debt sustainability considerations and with the Medium-Term Debt Management Strategy.

    c. Undertaking credit risk assessment of the application based on a credit scoring model.

    d. Considering whether:

        i. policy objectives can be achieved without a guarantee; and

        ii. the proposed option is the most cost-effective.

4.D Decision Making and Notification for Guarantees

55. The DMTC will prepare a report with a summary of their assessment and of the results of the credit risk assessment and make a recommendation to the Minister on whether the application for a guarantee should be approved. The process will then be as follows:

    a. The report will be sent to the Minister through the Secretary to the Treasury.

    b. The Minister, after considering the recommendation made by the DMTC, may approve or deny the request.

    c. The Minister’s decision will be communicated, through the Secretary to the Treasury, to the Director of DAD and the DMTC.

    d. The Director of DAD will prepare a Guarantee and a cabinet paper to be submitted by the Secretary for the Treasury for Cabinet approval.

    e. After Cabinet approval or rejection, the Secretary to the Treasury will:

i. request the Attorney General to prepare a legal opinion; and

ii. provide feedback to the Parent Ministry, with a copy to the requesting entity.

f. After Cabinet approval or rejection, the Minister will inform Parliament of the decision.

g. DAD will record its decision and how it came to the decision and will periodically review the evidence to look for ways of improving its decisions and the framework in which the decisions are made.

4.E Additional Procedures for On-Lending

56. After the terms of the main agreement between Government and the creditor have been negotiated and agreed, DAD will draft a subsidiary loan agreement and initiate negotiations with the SOE or statutory body.

57. Signing of the subsidiary loan agreement will occur after Government signs the main agreement.

58. The Ministry of Justice will be required to provide a legal opinion on the subsidiary loan agreement.

4.F Additional Procedures for Direct Borrowing

59. PFMS will conduct an assessment of the application for direct borrowing and make a recommendation to the Secretary to the Treasury through the DMTC Chairperson (Director DAD).

60. If the application is approved by the Secretary to the Treasury, PFMSD will prepare a Letter of Comfort or Consent Letter.

5 Recording, Monitoring and Reporting

5.A Recording

61. After issuing a guarantee or signing a subsidiary loan agreement, DAD will record details of the guaranteed or on-lent loan in the debt management system (CS Meridian).

62. Information to be recorded in the debt management system includes basic information on the guarantee or subsidiary loan agreement including signature date, amount, purpose and beneficiary details. It will also include information on the terms including interest, other fees or charges if applicable, repayment schedule and maturity date. Other information to be recorded includes information on guarantee fees, rollover of guarantees, defaults and bailouts.

63. DAD is the custodian of physical records including guarantees and subsidiary loan agreements. Electronic copies will be uploaded to the debt management system.

64. The back office of DAD will be responsible for maintaining an up-to-date database on guarantees, on-lent loans and recording direct borrowing (non-guaranteed debt) of SOEs and statutory bodies.

65. In collaboration with other parties, DAD and PFMSD will reconcile and validate the data at least once per year.

5.B Monitoring Performance Against the Limits

66. DAD and PFMSD will continuously monitor and analyse the portfolio of guarantees, on-lending, direct borrowing by SOEs and statutory bodies and guarantees issued by SOEs and statutory bodies.

67. DAD and PFMSD will monitor the stocks of guarantees, on-lent loans, and direct borrowing by SOEs and statutory bodies in relation to their respective limits.

5.C Monitoring of Contractual Obligations

68. For guarantees and subsidiary loan agreements, DAD together with PFMSD will continuously monitor the fulfilment of all undertakings and adherence to conditions in the guarantee or subsidiary loan agreement. The contractual obligations include payment of guarantee fees, disbursements by the lender and utilisation of funds.

69. The guaranteed entity or on-lending beneficiary will submit to the MoFEA progress reports on the utilisation of funds. Where necessary, the MoFEA will carry out physical monitoring of projects.

5.D Monitoring Payments for Guarantees and On-Lending

5.D.1 Monitoring of Payments Due

70. DAD will monitor payments due, and amounts paid for guaranteed or on-lent loans. This will allow the MoFEA to analyse the risk profile of its portfolio.

71. For on-lent loans, DAD will issue invoices stating the amounts to be paid, due dates and any arrears from previous billing periods. The invoices will state the accounts where the funds should be deposited.

72. Where escrow accounts are used and operational, the account will be monitored and the bank where the escrow account is held will be obliged to provide bank statements to both parties (MoFEA and the Guaranteed Entity).

5.D.2 Monitoring Utilisation of Funds

73. The guaranteed entity or on-lending beneficiary will submit to the MoFEA a progress report on the utilisation of funds. Where necessary, the MoFEA will carry out physical monitoring of projects.

5.E Reporting

74. Periodically, DAD will produce a status report on guarantees and on-lending and will share it with the Secretary to the Treasury. The status report will include information on the stock of guarantees and on-lent loans, the terms of guarantees and on-lent loans, guarantees that have materialised, been discharged or been called, performance against the guarantees, and assessment of risks and degree of exposure.

75. To promote transparency, information will be disseminated externally through annual and semi-annual debt reports, budget documents, financial statements, and fiscal risk statements. Information will also be disseminated through other platforms as part of Government’s external reporting requirements.

76. Guaranteed entities are required to submit financial reports to DAD for review. Among other things, financial reports should include transactions within the reporting period and expectation of default based on past debt servicing performance. These reports will be for internal use within the MoFEA.

77. In keeping with Section 100 of the Public Finance Management Act, 2022, guaranteed entities are obliged to submit annual reports or semi-annual reports to the MoFEA through their respective line ministries. At a minimum, reports should include the balance of the facility, cash flows, the financial position of the entity and liquidity and solvency ratios.

78. Guaranteed entities are required to notify the MoFEA of any possible occurrences that might compromise their financial position and affect their ability to service their debt.

6 Called Guarantee

6.A Pre-default Notification

79. If a guaranteed entity or on-lending beneficiary detects a possible default situation, it should do the following:

    a. Inform the parent ministry or agency and MOFEA as soon as possible.

    b. Use its best efforts to negotiate with the Guarantee Beneficiary for deferment of payments or forbearance.

    c. Give notice to the MoFEA as stipulated in the agreements between the parties.

6.B Action to Be Taken at the Time of Default

80. Upon giving notice and expiry of the agreed grace period, the Guarantee Beneficiary has the right to call upon the guarantee.

81. The MoFEA will assume the obligation and make good of all or part of the amounts due as stipulated in the Guarantee.

82. Depending on the agreement, the Ministry of Justice might be required to provide a legal opinion before the MoFEA assumes the obligation.

6.C Remedies to SOEs and Statutory Bodies as Guaranteed Entities

83. If an SOE or statutory body defaults on a guaranteed or on-lent loan, the MoFEA will take one of the following actions depending on the circumstances.

84. Subsidiary loan to the SOE or statutory body and debt restructuring:

    a. This method will be utilised where the SOE or statutory body is experiencing liquidity issues but remains solvent.

    b. Government will extend the amount to be paid on behalf of the SOE or statutory body as a loan. The loan will form an addendum to the main subsidiary loan agreement. Otherwise, the subsidiary loan agreement could be restructured.

    c. DAD and PFMSD will engage the Guaranteed Entity on the new terms of the restructured loan.

    d. The new terms will be submitted to the Secretary to Treasury and Minister for approval and the Ministry of Justice will be required to vet the agreement.

85. Recapitalisation:

a. This method will be used where evidence is available that the Guaranteed Entity is in distress and will remain in distress in the medium term.

b. The amounts settled by Government could be treated as a bailout. Audit opinion will be sought to ascertain the extent of the distress suffered by the Guaranteed Entity to allow for the bailout option.

c. With advice from DMTC, the Secretary to the Treasury could recommend a bailout with conditions or conditional recapitalisation to the Minister for approval.

d. Conditions might include a reform plan for the Guaranteed Entity or organisational restructuring. In addition, penalties will apply to the entity which may include, among other things, restrictions on future guarantee applications.

6.D Guaranteed Entities other than SOEs and Statutory Bodies

86. If a Guaranteed Entity that is not an SOE or statutory body defaults on a guaranteed loan, the MoFEA will endeavour to settle the obligation as committed. However, Government will take legal action to recover the funds.

7 Credit Risk Assessment and Expected Losses

7.A Credit Risk Assessment

87. Credit risk assessment will be employed to evaluate the creditworthiness of prospective guaranteed entities and on-lending beneficiaries in terms of the likelihood of them repaying the loan.

88. The MoFEA will use the Debt Guaranteed and Loan Assessment Tool (DGLAT) for purposes of credit risk assessment. The tool is set out in more detail in Annex 1.

89. The DGLAT tool begins with an assessment of the financial and business risks of an entity.

90. Financial risk indicators are based on financial ratios which assess an entity's profitability, liquidity and solvency.

91. Business risks are assigned a rating of credit positive, credit negative or credit neutral.

7.B Weighting

92. The different financial and business risk indicators are assigned weights, and an overall rating is produced for financial risks and business risks.

93. An overall rating is assigned to the entity based on the overall financial risk and business risk ratings.

7.C Probability of Distress

94. The probability of distress captures the likelihood of the entity defaulting on its loan and is calculated based on the weighted score obtained in the risk rating exercise.

95. There are several methods available for translating the weighted score to a probability of distress as set out in Annex 1.

7.D Expected Losses

96. The expected loss depends on the probability of default and the loss incurred in the event of default. Estimation of expected losses will be carried out as part of the credit risk assessment and will inform the assessment decision.

8 Annex 1: Debt Guarantees and Loan Assessment Tool

8.A Credit Risk Assessment

97. To ensure the decision to grant a guarantee considers the likelihood of default and the losses that would be incurred as a result, the MoFEA will submit applications for guarantees to a credit risk assessment.

98. The credit risk assessment has two main outputs: an overall risk rating which reflects the likelihood of a prospective Guaranteed Entity defaulting and the expected loss which reflects the magnitude of the potential liability to Government if the Guaranteed Entity were to default.

99. The MoFEA will use the Debt Guaranteed and Loan Assessment Tool (DGLAT) for purposes of credit risk assessment.

8.B Risk Rating

8.B.1 Financial and Business Risk Indicators

100. The DGLAT evaluates the creditworthiness of a prospective Guarantee Beneficiary in terms of likelihood they will default on the prospective guaranteed loan. The credit risk methodology begins by looking at financial risk and business risk indicators.

101. The financial risk indicators are based on financial ratios which asses an entities profitability, liquidity and solvency. Depending on its value, each indicator is assigned a rating from category 1 to category 5, with the former being the lowest and the latter the highest.

102. Business risks ratings are based on subjective judgements about different aspects of an entity's business. A rating of credit positive, credit negative or credit neutral is assigned to each of the following business risk categories: industry risk, competitive position, board and management, governance, market risk, liquidity, legal and regulatory and other factors.

8.B.2 Overall Risk Ratings

103. Each financial risk indicator is assigned a weight and based on these an overall financial risk rating from category 1 to 5 is assigned to each entity based on the weighted average of the scores for the different indicators.

104. Based on the overall financial risk rating and business risk rating, an overall risk rating is assigned to the entity from categories 1 to 5.

8.C Calculating Expected Losses

105. As well as assessing the probability of default, the credit risk assessment also assesses the losses that would be incurred in the event of default. There are two concepts that are utilised for his purpose: maximum loss and expected loss.

106. The maximum loss given default is the total amount Government would be liable for if all guaranteed loans were defaulted on.

107. The expected loss given default for a guaranteed loan is the expectation of the losses. It is defined as follows:

   a. $ELGD = ED \times PD \times LGD$, where ED is the outstanding amount of the loan at the time of default, PD is the probability of distress and LGD is the loss given distress.

8.C.1 Probability of Distress

108. The probability of distress (PD) takes a value between zero and one. It is calculated using the weighted score that was obtained during the risk rating exercise. There are a number of ways to translate the risk rating to a value for the PD including:

   a. using observed borrowing costs by rating category;
   b. mapping risk rating categories to rating agency rating categories and using default frequency data;
   c. defining a theoretical transition matrix and calibrating it with third-party and market data; and
   d. using risk assessment methodologies other than risk ratings.

8.C.2 Loss Given Distress

109. Loss given distress (LGD) is the loss Government will incur if a Guaranteed Entity defaults on a guaranteed loan. It is usually expressed as a percentage of the outstanding amount of the loan at the time of default. Factors considered in arriving at a figure for LGD include:

   a. seniority of the Guarantee Beneficiary’s claim (the more senior the claim, the lower the LGD);

b. risk sharing relationship between the guarantor and the lender (where the guarantor takes the first loss, the recoveries will be lower than where losses are shared pari passu);

c. leverage, liquidity and cash generation capacity of the borrower (lower LGD where borrower can meet more of the debt service payments and there is a better chance of them repaying Government for any losses sustained).