GUARANTEE POLICY

Solomon Islands Government

Approved by Minister of Finance

10 September 2016

GUARANTEE POLICY

Contents

ABBREVIATIONS

ABL	Annual Borrowing Limit
CBSI	Central Bank Solomon Islands
DMAC	Debt Management Advisory Committee
DMF	Debt Management Framework
DMS	Debt Management Strategy
DMU	Debt Management Unit
ERU	Economic Reform Unit
IFI	International Financial Institution
MoFT	Ministry of Finance and Treasury
NDS	National Development Strategy
NIIP	National Infrastructure Investment Plan
NPF	National Provident Fund
PFMA	Public Financial Management Act
SIG	Solomon Islands Government
SOE	State Owned Enterprise
SCO	Statement of Corporate Objectives

EXECUTIVE SUMMARY

A guarantee provided by government can take many forms. This Guarantee Policy governs the use of guarantees, as defined in the *Public Financial Management Act (PFMA) 2013.* That is, a guarantee referred to in this Policy (i.e. a Sovereign Guarantee) is a 'commitment by the Government to repay the financial liabilities of another entity should that entity default'. Under such arrangements, the Solomon Islands Government (SIG) would act as 'Guarantor' of a financial obligation committed to by a 'Guarantee Beneficiary', in favour of a 'Guaranteed Entity'. Guarantee arrangements are formalised by way of a Guarantee Agreement between all parties.

Through the provision of guarantees, SIG can support strategically important projects that aid national development. Guarantees are typically required if the prospective financier of a project, in the absence of a guarantee, is unwilling to take on the risk of the project or is proposing to charge an interest rate that makes the project economically unviable.

This Policy is one component of the Solomon Islands Debt Management Framework (DMF) (refer to section 3.2 of the Debt Management Strategy (DMS)). Consistent with the legal provisions contained in the PFMA 2013, all guarantee proposals will be evaluated by the Debt Management Advisory Committee (DMAC), which will provide advice to the Minister of Finance on the merits of providing consent for each proposal.

This Policy upholds the fundamental principles of sound Government decision making (accountability and transparency) and promotes the prudent use of public resources. This Policy provides for guarantees to be provided to Guarantee Beneficiaries that are sub-national entities, private companies and foreign entities, which will be considered on an exceptions basis only.

Consistent with the *SOE Act 2007*, this Policy seeks to encourage State Owned Enterprises (SOE) to operate profitable and efficient businesses, whilst taking market distortion considerations into account where relevant. A Guarantee fee will be charged by SIG in most circumstances where a guarantee is provided. The size of the fee will depend on a number of factors, including the broader economic benefits (that include identifiable social benefits) that are expected to be derived from the implementation of the project.

SIG will only guarantee projects that have net projected cash flows sufficient to make the scheduled repayments of the underlying loan or contract and contribute to the future capital requirements of the entity.

1. INTRODUCTION

1.1. Definition of Guarantee

A 'Guarantee' provided by a government can take many forms. In this Guarantee Policy, a *guarantee* is, as defined in the *Public Financial Management Act (PFMA) 2013*, a:

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

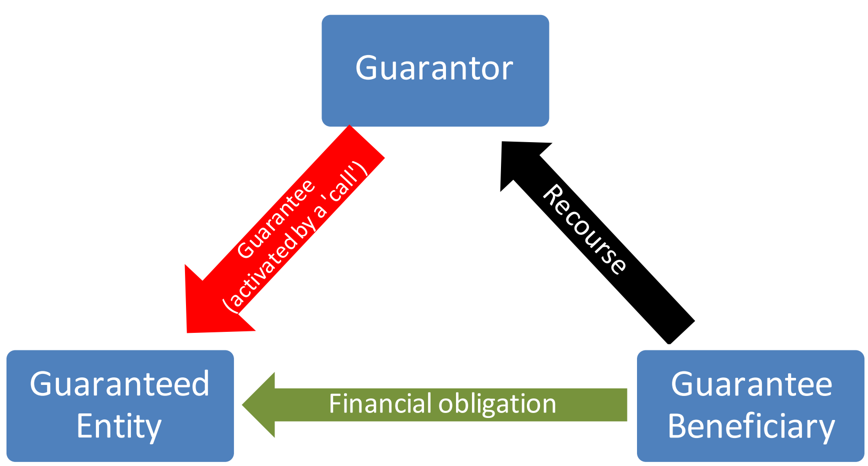
In the guarantee definition provided above, the:

1. Government is the ***'Guarantor'***;
2. entity whose financial obligation *payments* are covered by the Guarantor is the '***Guarantee Beneficiary'***; and
3. entity whose financial obligation *receipts* are covered by the Guarantor is the ***'Guaranteed Entity'***.

Guarantees are typically documented by way of a ***'Guarantee Agreement'***. The occurrence of a ***'trigger event'*** under a Guarantee Agreement gives the Guaranteed Entity the right to request from the Guarantor payment of the Guarantee Beneficiary's unpaid financial obligations. If the Guaranteed Entity chooses to exercise this right, then a ***'call'*** is made on a guarantee. Should a guarantee be called, the Guarantor will typically have the legal right, depending on the Guarantee Agreement, to demand reimbursement or ***'recourse'*** from the Guarantee Beneficiary. The obligations and financial flows of a guarantee arrangement are illustrated in Figure 1 below.

Guarantees called in times of economic and fiscal difficulty can be expected to precipitate or exacerbate a country's financial crisis.

FIGURE 1: GUARANTEE ARRANGEMENT



1.2. PFMA legal provisions relating to guarantees

Refer to section 3.2.1.1 of the DMS for a summary of legal provisions included in the PFMA that relate to guarantees. Two key statutory provisions are outlined below.

1.2.1. Ministerial authorisation

The PFMA requires all guarantees to be authorised by the Minister of Finance (refer to section 3.2.1.1.4 of the DMS).

1.2.2. Debt Management Advisory Committee (DMAC) evaluation

Before making a decision on whether to authorise a guarantee, the Minister of Finance is required under the PFMA to seek out the advice of the DMAC on whether to authorise. The DMAC will therefore evaluate every guarantee proposal in order to provide a properly informed recommendation to the Minister of Finance.

1.3. Scope of this policy

The scope of this Policy is to provide evaluation and decision making guidance for prospective Guaranteed Entities, prospective Guaranteed Beneficiaries, DMAC secretariat (i.e. the Debt Management Unit (DMU) within the Ministry of Finance and Treasury (MoFT)), the DMAC and the Minister of Finance, with respect to ***individual proposals*** for guarantees.

The provisions contained in this Policy accede to the DMS. It is important to note that the statutory provisions included in the PFMA and the rules outlined in the DMS related to SIG Guarantees are not repeated in this Policy.

1.3.1. Explicit guarantees (contingent liabilities)

This Policy only governs legally binding Government guarantees that are provided to cover a Guarantee Beneficiary's unpaid financial obligations that result from the following **'trigger events'**:

- Loan defaults (e.g. direct loan agreement between a sub-national entity and a commercial lender); or a
- Breach of contract (e.g. on a power purchase agreement).

1.3.1.1 Non-permissible guarantees

Although the PFMA defines guarantees provided by sub-national entities (i.e. a State Owned Enterprise (SOE) or provincial government) as Government borrowing, sub-national entities are not permitted to provide guarantees under the DMS (Refer to section 8.2 of the DMS). Sub-national entities have limited capacity to manage and administer guarantees.

1.3.2. Implicit guarantees (contingent liabilities)

Implicit contingent liabilities are not governed by this Policy. Implicit contingent liabilities are liabilities that might be taken onto the central government's balance sheet if a public sector related entity defaults on its financial obligations.

Implicit contingent liabilities will be recognised by SIG on its balance sheet when a sub-national entity enters into a financial obligation (i.e. direct borrowing).

The entering into of financial obligations by sub-national entities is governed by the Sub-national Entity Direct Borrowing Policy.

1.3.3. Other guarantees not in the scope of this Policy

There are other types of guarantees that are not governed by this Policy. These other guarantees typically commit a government to bear some, or all, of the downside risk of a project, other than as a shareholder, lender, customer, or taxer of the project. For example, a government could be asked to guarantee;

- a minimum foreign exchange rate (Currency Risk Guarantee);
- against a seizure of project assets (Expropriation Guarantee); or
- a certain regulatory environment for investors (Regulation Guarantee).

1.4. Objectives of this Policy

Primary objectives of this Policy are to:

1. give operational effect to the legal provisions contained in the PFMA relating to guarantees that are covered by the scope of this Policy (refer to section 3.2.1.1 of the DMS);
2. provide operational clarity to the DMAC Secretariat on how to evaluate proposed guarantees; and
3. provide clarity to prospective Guarantee Beneficiaries, Guaranteed Entities and the DMAC on the evaluation process for proposed guarantees that are covered by the scope of this Policy (this policy is to be read in conjunction with the ***Guarantee Evaluation Guidelines***).

Secondary objectives of this Policy are to promote:

1. the efficient, effective and ethical use of public resources; and
2. accountability in Government decision making; and
3. transparency in Government decision making.

1.5. Administration of this Policy

The DMU, in collaboration with the Economic Reform Unit (ERU), will be responsible for administering this Policy.

1.6. Review of this Policy

This Policy shall be reviewed at least once every five years and amended accordingly. Reviews should focus on the:

- historical performance of Guarantee Beneficiaries with respect to their guarantees;
- historical performance of SOEs with respect to their borrowing from commercial sources; and
- different types of guarantees that have been proposed by stakeholders.

2. GENERAL PRINCIPLES OF GUARANTEES

2.1. Why would government consider providing guarantees?

Central government could issue guarantees for a range of reasons, some of which may represent good policy and some not. 'Good' guarantees promote infrastructure projects in the public interest. 'Bad' guarantees, for example, support uneconomic projects for political reasons[1].

Guarantees should be provided to promote projects that benefit the public. They should be considered by government when a prospective funder of a project is, in the absence of a guarantee, unwilling to take on risk ('capital market failure') or is proposing to charge an uneconomical interest rate because the project, for example:

- requires long term financing (i.e. typically more than twenty years);
- is very complex;
- is exposed to many unknowns;
- has appreciable political risks; or
- is unique and therefore difficult for the market to assess and price.

2.2. Guarantees and moral hazard

Moral hazard refers to a situation where a party is inclined to take on more risk, than they otherwise would, because the costs associated with the risks materialising will be borne by another party. In the case of SIG guaranteeing a loan, this additional risk may manifest itself in the form of, for example, poor due diligence and/or loan agreement monitoring by the Guaranteed Entity.

[1] Providing a guarantee does not require a Budget appropriation. Guarantees therefore provide an opportunity for uneconomic, or nonviable, projects to be supported without being properly scrutinised through the Budget process.

3. RISKS ASSOCIATED WITH GUARANTEES

3.1. Possible risks for SIG

A Government guarantee is usually formalised by way of a guarantee agreement between a Guarantor, Guarantee Beneficiary and Guaranteed Entity.

When a loan or contractual obligation is being guaranteed as part of a project, the associated guarantee agreement will typically include (or refer to) a risk allocation that assigns the management of each risk (that might contribute to a default, or breach of contract) to a party to the agreement. The Guaranteed Entity has a right to make a call on a Guarantor only if a default has been caused by a trigger event that has been caused by the materialisation of a risk that has been assigned to the Guarantor. For this reason, each risk should be allocated to the entity that is best placed to manage and mitigate the respective risk.

Some common risks that are allocated in guarantee agreements are described in the below subsections. It should also be noted that a risk allocation should have a time dimension. For instance, if the guarantee is supporting a project, then it might be appropriate to allocate a specific risk to different entities at different stages of the project (e.g. ‘planning and development’ phase. ‘financing’ phase, ‘construction’ phase etc.).

In addition to the risks outlined below, government guarantees expose the providing Government to the normal loan/obligation risks of default on the underlying obligation that is being guaranteed. As such, before entering into a guarantee agreement, SIG should understand the risk of default on the underlying obligation that is being guaranteed. Refer to section 3 of the Sub-national Direct Borrowing Policy for a summary of risks that impact on the risk of default on loan obligations.

3.1.1. Sovereign force majeure risk

This risk relates to a default on a loan or breach of contract by a Guarantee Beneficiary or project arising due to war, terrorism and sabotage, general strike, riot, civil disturbance or actions/inactions of government.

There is a fair and reasonable expectation that SIG, as Guarantor, is in a better position than the Guarantee Beneficiary and/or the Guaranteed Entity to manage this risk.

As such, it is reasonable for SIG to guarantee a trigger event arising from a sovereign force majeure event.

3.1.2. Natural force majeure risk

This risk relates to a default on a loan or breach of contract by a Guarantee Beneficiary or project arising due to storm, flood, fire, landslide, earthquake or tsunami etc.

There is a fair and reasonable expectation that the Guarantee Beneficiary and/or the Guaranteed Entity are in a better position than SIG, as Guarantor, to manage this risk. For example, project proponents (e.g. Guarantee Beneficiary and/or the Guaranteed Entity) would typically be in a better position, as project designers, to mitigate the consequences of earthquake.

As such, there should be good justification provided by the Guarantee Beneficiary and/or the Guaranteed Entity if SIG is to guarantee a trigger event arising from a natural force majeure event. Guarantee Beneficiaries and/or Guaranteed Entities should be requested to insure the project they are developing against natural force majeure events.

3.1.3. Demand for project outputs risk

This risk relates to a default on a loan or breach of contract arising due to inadequate demand for the good or service that is to be provided by the project.

There is a fair and reasonable expectation that the Guarantee Beneficiary and/or the Guaranteed Entity are in a better position than SIG, as Guarantor, to manage this risk. For example, project proponents (e.g. Guarantee Beneficiary and/or the Guaranteed Entity) would typically be in a better position, as project operators, to mitigate the consequences of inadequate demand.

As such, there should be good justification provided by the Guarantee Beneficiary and/or the Guaranteed Entity if SIG is to guarantee a trigger event arising from inadequate demand for the good or service to be provided by the project.

3.1.4. Legal, regulatory and policy risk

This risk relates to a default on a loan or breach of contract arising due to a change, unilaterally made by the Government, to the legal, regulatory and policy environment.

There is a fair and reasonable expectation that SIG, as Guarantor, is in a better position than the Guarantee Beneficiary and/or the Guaranteed Entity to manage this risk.

As such, it is reasonable for SIG to guarantee a trigger event arising from a change to the legal, regulatory and policy environment.

3.1.5. Project development cost risk

This risk relates to a default on a loan or breach of contract arising, due to the materialisation of an unforeseen increase in project development costs.

There is a fair and reasonable expectation that the Guarantee Beneficiary and/or the Guaranteed Entity are in a better position than SIG, as Guarantor, to manage this risk. For example, project proponents (e.g. Guarantee Beneficiary and/or the Guaranteed Entity) would typically be in a better position, as project developers, to mitigate this risk.

As such, there should be good justification provided by the Guarantee Beneficiary and/or the Guaranteed Entity if SIG is to guarantee a trigger event arising from a blowout in development costs.

3.2. Risk evaluation

SIG should conduct an evaluation of the various risk exposures as project promoters seeking a guarantee are typically motivated to inaccurately allocate and estimate the risks. The process of objective assessment has the benefit of focussing attention on how to conduct a risk allocation. The process should involve:

1. identifying the risks by project phase;
2. quantifying the risks; and
3. appropriately allocating the responsibility for risks to the Guarantor, Guarantee Beneficiary and Guaranteed Entity.

Caps on exposure and on the value of a guarantee should be considered. This will limit SIG's potential financial loss in the event that the guarantee is called.

Risks should be allocated to the guarantee agreement signatory that has the greatest capacity to manage and mitigate the respective risk.

The guarantee should also be secured by a charge on the Guarantee Beneficiary's assets to strengthen SIG's financial position in the event that a guarantee is called (although this will not assist in the case of SOEs where SIG is the sole shareholder). This will also limit the Beneficiary from creating further encumbrances on its assets.

3.3. Cost-benefit analysis of risk

SIG should require, for high value guarantees, the Guarantee Beneficiary and/or Guaranteed Entity to commission and pay for an independent and objective cost-benefit analysis of the risks associated with providing the guarantee (Most reputable project promoters would require this in any case).

4. ELIGIBILITY FOR GUARANTEES

4.1. Entity

4.1.1. Guarantee Beneficiary

The Minister ***will only*** consider authorising guarantees for the benefit of the following beneficiaries:

- SOEs that:
    - are compliant with the MoFT document, titled 'SOEs Guide to the Preparation of Statements of Corporate Objectives (SCO)';
    - have no formal debt arrears;
    - have no National Provident Fund (NPF) contribution arrears; and
    - have no tax arrears.
- Provincial Governments that:
    - have no formal debt arrears;
    - have no trade creditor arrears;
    - have no NPF contribution arrears; or
    - have no tax arrears.
- Private domestic companies (including joint ventures) that:
    - have no formal debt arrears;
    - have no NPF contribution arrears; and
    - have no tax arrears.
- Foreign entities (multilateral, public or private and including joint ventures) that:
    - have no employee pension contribution arrears;
    - have no tax arrears.

The Minister ***will not*** authorise Guarantees for the benefit of the following beneficiary type:

- private individuals.

SIG does not have the capacity to assess the credit worthiness of individuals, and it also raises considerable risks around accountability, transparency and prudent use of public resources.

4.1.2. Guaranteed Entity

The Minister ***will only*** consider authorising the provision of guarantees to:

- International Financial Institutions (IFIs) (or subsidiaries of);
- Solomon Islands incorporated entities, including banks, that:
    - have no formal debt arrears;
    - have no NPF contribution arrears; and
    - have no tax arrears.
- Foreign incorporated entities, including banks, that:
    - exhibit a high level of credit worthiness;
    - have no employee pension contribution arrears; and
    - have no tax arrears.

4.2. Project

4.2.1. Sub-national entity projects

Eligible projects to be backed by a guarantee

The Minister ***will only*** consider authorising a Government guarantee for the benefit of a sub-national entity if the project that is to be supported by the guarantee:

- Complies with sections 8.13, 8.14 and 8.15 of the DMS; and
- has previously been included by an SOE in a SCO provided to the MoFT (N.B. This only applies to a Government guarantee being proposed by a SOE); and
- ***exhibits*** commercial like characteristics (refer to section 4.2.3 of this Policy) if the sub-national entity is a SOE; and
- is ***expected*** to deliver a net economic return (refer to Appendix 3 of the DMS for further information on net economic return) to the Solomon Islands.

Ineligible projects to be backed by a guarantee

The Minister ***will not*** consider authorising a Government guarantee for the benefit of a sub-national entity project if the project that is to be supported by the guarantee:

- Complies with sections 8.13, 8.14 and 8.15 of the DMS; but
- ***does not exhibit any*** commercial like characteristics (refer to part 4.2.3 of this Policy); but
- is ***expected*** to deliver a net economic return (refer to Appendix 3 of the DMS for further information on net economic return) to the Solomon Islands.

If a project is deemed ineligible to be supported by a guarantee, as per the criteria listed above, the Government could consider funding (in full or in part) the project either through the development Budget.

4.2.2. Private domestic company or foreign entity projects

Eligible projects to be backed by a guarantee

The Minister ***will only*** consider authorising a Government guarantee for the benefit of a private company project, in exceptional circumstances, if the project that is to be supported by the guarantee:

- Complies with sections 8.13 and 8.14 of the DMS;
- ***does not exhibit only*** commercial characteristics (refer to part 4.2.3 of this Policy);
- is ***expected*** to deliver a net economic return (refer to Appendix 3 of the DMS for further information on net economic return) to the Solomon Islands; and
- would not otherwise be developed by
    - SIG;
    - a SOE;
    - a Provincial Government; or another
    - private company.

4.2.3. Commercial like characteristics

Commercial like characteristics are exhibited by a project if the *intent* of the project is to generate sufficient income, by charging market prices, to compensate for the factors of production (labour and capital). In practice, this means implementing a project to generate sufficient revenue to cover the repayment of capital and meet operating expenses (i.e. interest on borrowings, wages for employees and other operating costs), while also providing the required risk-adjusted return on equity (this will reflect the opportunity cost of capital and risks associated with the specific economic activity). Exhibiting adequate capacity to repay debt capital is essential for a project to exhibit commercial like characteristics.

4.2.4. Ineligible uses of guaranteed funds

SIG will not guarantee debt financing or a contract that aims to:

- fund the recurrent budget of any entity;
- cross subsidize SOEs;
- cross subsidize Government entities; or
- support poor management.

5. PROPOSAL EVALUATION

5.1. Evaluating proposed guarantee proposals

The process for proposal evaluation, which is the precursor to a DMAC recommendation to the Minister on whether to authorise a Government guarantee, is outlined in the Guarantee Evaluation Guidelines (refer to 'Evaluation process – four pool approach' in section 2 of the Guidelines).

An entity that is proposing to be a Guarantee Beneficiary must comply with the evaluation process outlined in the Guarantee Evaluation Guidelines.

5.1.1. Guarantee Evaluation Guidelines

This Policy should be read by stakeholders (e.g. entities that wish to be a Guarantee Beneficiary) in conjunction with the Guarantee Evaluation Guidelines.

Those Guidelines outline the process to be followed by all stakeholders for the evaluation of guarantee proposals.

They aim to align, as closely as possible, the timing of the evaluation process with the annual Development Budget process, whilst providing clarity for all stakeholders as to what their respective responsibilities are in the evaluation process.

In exceptional circumstances, MOFT recognises that there may be a need to evaluate some proposed Government guarantee proposals in a timeframe that is inconsistent with the annual Development Budget process. These circumstances are outlined in the Guidelines.

5.1.2. Principle of aligning to Development Budget process

The evaluation process outlined in this Policy and the Guidelines uses the National Development Strategy (NDS), National Infrastructure Investment Plan (NIIP) and the incumbent Government's policy statement as guides (refer to section 8.14 of the DMS) to prioritise proposed Government borrowing proposals.

The aim of the prioritisation process is to optimise the net economic return that can be derived from Solomon Islands' limited borrowing capacity.

6. GUIDANCE ON ACCEPTABLE GUARANTEE AGREEMENT TERMS

SIG needs to evaluate Guarantee Agreement proposals and negotiate the maximum benefit for Solomon Islanders at an acceptable level of risk.

6.1. Appropriate risk allocation

It is crucial that any Guarantee Agreement entered into by SIG has been evaluated for risk, as outlined above in section 3.2 (Risk Evaluation) of this Policy.

6.2. Denominated currency

Key point: *SIG should explicitly seek to negotiate guarantees to be denominated in SBD rather than in a foreign currency.*

A foreign currency denominated loan or contract that requires a guarantee will typically require the guarantee to be denominated in the same foreign currency. It would be unusual for a Guaranteed Entity to seek a SBD denominated guarantee for a foreign currency denominated loan or contract.

The Guarantor is therefore exposed on two fronts if a foreign currency denominated guarantee is granted. Firstly, the foreign currency risk exposure on the loan or contract increases the risk that a trigger event occurs and the guarantee is called. Secondly, the SBD value of the guarantee is exposed to upward movements due to foreign currency fluctuations.

6.3. Sunset clause

Key point: *SIG should explicitly negotiate a limitation on the period for which a guarantee applies by seeking the inclusion of a 'sunset clause'.*

The Government's exposure to the guarantee should be limited with the inclusion of a sunset clause. The expiry of the sunset clause should be negotiated between the Guarantor and Guaranteed Entity. When negotiating a sunset clause, the Government should consider: 1) when the project can be expected to operate on a commercial like basis; 2) at what point in time the risks or a trigger event subside; and 3) the principle of inter-generational equity.

6.4. 'Joint' or 'Several' or 'Joint and several'

Key point: *SIG should explicitly negotiate guarantees on a 'several' basis.*

The basis of the guarantee is especially relevant in joint venture type arrangements where SIG, or a SIG related entity (i.e. SOE or Provincial Government), is a shareholder partner. Guarantees provided on a 'several' basis limits the guarantee to a proportion of the total amount outstanding, based on the respective shareholding.

A guarantee provided on a 'joint' basis, gives the Guaranteed Entity the *right* to call the guarantee on any one Guarantor, regardless of their respective shareholding. SIG should avoid guarantees sought on this basis.

A guarantee provided on a 'joint and several' basis, gives the Guaranteed Entity the *choice* to call the guarantee on any one Guarantor, regardless of their respective shareholding. SIG should avoid guarantees sought on this basis.

The additional exposure over and above the respective shareholding of SIG, or a SIG related entity, on a guarantee provided on a 'joint' or 'joint and several' basis, should be appropriately reflected in the setting of the 'Guarantee fee'.

6.5. Interest charged on underlying loan

The provision of a guarantee by SIG should mean that the Guaranteed Entity is willing to charge an interest rate, lower than what would otherwise have been charged without the provision of the guarantee, to the Guarantee Beneficiary. This should occur as the guarantee transfers part of their credit risk exposure to the Guarantor (i.e. SIG).

6.6. Guarantee Beneficiary credit covenants

SIG needs to ensure that measures are included in underlying loan/contractual agreements that allow the risk of the guarantee to be mitigated and monitored. SIG therefore needs to play an active role in negotiating the loan agreement and other legal documents. This is essential if SIG is required to issue a guarantee. Where SIG provides a guarantee, it needs to be as assiduous as if lending money itself. Clauses should be included in the guarantee agreement that require the Beneficiary to:

- establish their legal status;
- use the loan only for the intended purpose;
- fulfil conditions precedent for disbursement such as stages of contract fulfilled;
- take out insurance;
- provide information such as audited financial statements in a timely manner;
- notify the Lender and Guarantor if a default is likely;
- maintain minimum debt to equity ratios (including restricting excessive dividend payments);
- maintain minimum working capital/liquidity ratios;
- provide collateral or security for the loan; and
- maintain value of collateral.

These are known as positive covenants. There should also be negative covenants that prevent the Beneficiary from:

- mortgaging its assets as security for other undertakings;
- taking out further loans; or
- overly increasing debt/equity ratios through excessive dividend payments.

The consequences of a call on a guarantee are serious and therefore SIG needs to prevent situations that lead to a guarantee trigger event. The guarantee agreement should strike a balance between: 1) imposing penalties for breach of covenants that create incentives for the Guarantee Beneficiary not to contribute to a trigger event; and 2) providing the Guarantee Beneficiary with sufficient time or opportunity to remedy covenant breaches.

6.7. Limit value of guarantee

Key Point: *The quantum of any guarantee that is provided by SIG should be clearly defined and limited where appropriate.*

Caps on exposure and on the value of a guarantee should be incorporated into the Guarantee Agreement. This will limit SIG's potential financial loss in the event that the guarantee is called.

6.8. Payment of guarantee

Key Point: *The Guarantee Agreement should outline the process to determine and pay a guaranteed amount, should a legitimate call on a SIG guarantee be made.*

Any Guarantee Agreement that SIG enters into should, if a legitimate call on a SIG guarantee is made, allow SIG to:

- take on the payment schedule that is in default; or
- restructure the guaranteed amount so that it is not payable immediately.

6.9. Guarantor recourse

Key Point: *A process outlining recourse measures should be included in the Guarantee Agreement.*

Guarantee Agreements should identify and agree on a plan outlining how SIG will seek recourse should a legitimate call on a guarantee occur. This must be credible, but not include the option of nationalization (or any other variation on SIG running the business to make good losses). The plan could include the capitalisation of any guaranteed amount, paid by SIG on behalf of a Guarantee Beneficiary, as a debt owing to SIG on the Beneficiary's balance sheet.

Where possible, security should be taken over Guarantee Beneficiary assets to align incentives between the Guarantee Beneficiary and the Guarantor, and to reduce the negative financial impact on SIG should a guarantee be called.

SIG also needs to consider what happens to the project if the Guarantee Beneficiary defaults on their obligation. In the case of SOEs, SIG will not only be held responsible for meeting the obligation, but will also be under pressure to assist the defaulting SOE financially. In any case, given that the project has been identified as a priority as part of the 'prioritisation process', the Government is likely to be under pressure to take over the project. These scenarios should be thought-out during the underlying loan agreement and Guarantee Agreement negotiation phase.

Procedurally, as a first step to dealing with a trigger event, DMU will **immediately** notify the Guarantee Beneficiary demanding immediate payment. The PS Finance will write to the Guarantee Beneficiary demanding immediate payment. If the default is not rectified, the Minister of Finance will write to the head of the Guarantee Beneficiary to demand immediate payment of the amount due to the Guaranteed Entity, seek an explanation of the default and outline punitive measures that will apply should the default not be rectified.

For sub-national entities, punitive measures could include the Minister:

- taking possession of the encumbered assets;
- listing the entity on a publicly available list of defaulting entities, posted on the MoFT website;
- informing Cabinet that the entity has defaulted; and/or
- deeming the entity ineligible for future SIG guarantees or on-lending arrangements.

With respect to private companies, clauses should be included that provide for the transfer of assets to SIG that have been encumbered as part of the Guarantee Agreement.

6.10. Guarantee fee – Setting the fee

Key point: *The Guarantee fee, to be paid by the Guaranteed Beneficiary to SIG (the Guarantor), will be determined by taking into account the following factors:*

- *SIG's administrative cost of managing the guarantee arrangement;*
- *the denominated currency of the guarantee;*
- *the denominated currency of the guaranteed loan or contract;*
- *the type of interest payments due on a guaranteed loan;*
- *the nature of the payments due on a guaranteed contract;*
- *the nature of any sunset clause included in the guarantee arrangement;*
- *the perceived credit worthiness of the Guarantee Beneficiary; and*
- *the project's expected 'net economic return'.*

The PFMA provides for the Minister of Finance to impose a fee to cover the cost of administration and for bearing additional risk through the provision of a guarantee. The purpose of charging a Guarantee fee (i.e. akin to a premium) is to act in a similar way to an insurance premium. That is, to cover the cost of issuing guarantees over the long term. The Guarantee fee should not be used as a source of revenue for Government. Guarantee fees received by Government should be set aside in the Debt Servicing Account against future calls on guarantees.

Each of the factors considered in the determination of the Guarantee fee are described below.

6.10.1. Administrative cost

SIG will incur operational costs when administering guarantee arrangements. These costs relate to, for example, the monitoring and reporting of the guarantee arrangement and the Guarantee Beneficiary.

6.10.2. Denominated currency of the guarantee

The component of the Guarantee fee that is attributed to the denominated currency of the guarantee arrangement will be based on the; 1) historical volatilities of the denominated currency or currencies of the guarantee; 2) term of the guarantee; 3) prevailing FX Policy regime administered by the Central Bank Solomon Islands (CBSI); and 4) perceived risks of a prolonged devaluation of the SBD.

The denominated currency of the guarantee arrangement will not be factored into the calculation of the Guarantee fee if the guarantee is denominated in SBD.

6.10.3. Denominated currency - Underlying loan/contract credit risk

The component of the Guarantee fee that is attributed to the denominated currency of the underlying loan or contract will be based on the; 1) historical volatilities of the denominated currency or currencies of the guarantee; 2) term of the guarantee; 3) prevailing FX Policy regime administered by the CBSI; and 4) perceived risks of a prolonged devaluation of the SBD.

The denominated currency of the underlying loan or contract will not be factored into the calculation of the Guarantee fee if the underlying loan or contract is denominated in SBD.

6.10.4. Interest rate - Underlying loan credit risk

The component of the Guarantee fee that is attributed to the interest rate applied to the underlying loan will be based on; 1) whether the interest rate is fixed or floating; 2) if it is a fixed-rate, the level of the rate; and 4) if it is floating-rate, the level of the reference rate in relation to historical levels.

6.10.5. Contract payments - Underlying contract credit risk

The component of the Guarantee fee that is attributed to the contract payments applied to the underlying contract will be based on; 1) whether the payments are fixed or variable.

6.10.6. Length of sunset clause

The component of the Guarantee fee that is attributed to the guarantee sunset clause will be based on the length of the clause. The longer the sunset clause, the larger the positive adjustment to the Guarantee fee required.

6.10.7. Perceived credit worthiness of the Guarantee Beneficiary

The component of the Guarantee fee that is attributed to the perceived credit worthiness of the Guarantee Beneficiary will be based on the results of the 'Guarantee Beneficiary credit risk assessment' performed by the DMU as part of the 'proposal assessment' (refer to section 6.1.1 of the Guarantee Guidelines).

Upon completion of the Guarantee Beneficiary credit risk assessment, the DMU will assign the entity with a credit rating that will characterise the entity's likelihood of instigating a trigger event due to entity insolvency. The possible credit ratings are:

1. credit worthy; or
2. not credit worthy.

6.10.8. Project's expected 'net economic return'

The component of the Guarantee fee that is attributed to the project's ***expected*** net economic return (refer to Appendix 3 of the DMS for further information on net economic return), which will be determined by the MoFT as part of the 'proposal assessment'. Each project will be assigned a rating that characterises the project's broader economic benefit.

A project's broader economic benefit will be rated as being either:

1. no benefit;

2. small;
3. moderate; or
4. large.

7. RECOGNITION, REPORTING AND MONITORING OF GUARANTEES

7.1. Recognition and reporting as Government borrowing

All Government guarantees shall be recognised and reported, on a 100% of face/notional value basis, as Government borrowing in accordance with sections 8.4 and 8.5 of the DMS.

7.2. Counting against the Annual Borrowing Limit (ABL)

In accordance with section 8.6 of the DMS, all Government guarantees should be counted on a 100% of face/notional value basis against the ABL year in which the guarantee is recognised as a Government borrowing.

7.3. Monitoring

SIG should monitor the performance of Guarantee Beneficiaries so that measures can be taken if it looks like there is an increased risk that the Guarantee is to be called. SIG should monitor the beneficiaries:

- compliance with their respective Guarantee Agreement covenants;
- promptness of repayments on the underlying loan that is guaranteed; and
- quality of management and operations.

For guarantees relating to legal, regulatory and policy risk, the DMU should make the relevant SIG entities (e.g. ministries) aware of what has been agreed in the Guarantee Agreement so that SIG doesn't contribute to the occurrence of a trigger event.