

ON-LENDING POLICY

Solomon Islands Government

Approved by Minister of Finance

10 September 2016

ON-LENDING POLICY

Contents

ABBREVIATIONS	5
EXECUTIVE SUMMARY	6
1. INTRODUCTION.....	7
1.1. Definition of on-lending	7
1.2. How does on-lending work?	7
1.3. Why do on-lending in the Solomon Islands?	8
1.4. PFMA legal provisions relating to on-lending arrangements	8
1.4.1. Ministerial authorisation.....	8
1.4.2. Debt Management Advisory Committee (DMAC) evaluation.....	8
1.5. Scope of this Policy	8
1.5.1. Policy rationale for on-lending grant funds received by SIG	8
1.5.2. Non-permissible on-lending arrangements	9
1.6. Objectives of this Policy	9
1.7. Administration of this Policy	9
1.8. Review of this Policy	9
2. GENERAL PRINCIPLE OF THIS ON-LENDING POLICY	10
3. RISKS ASSOCIATED WITH ON-LENDING	11
3.1. Financial risks for SIG	11
3.1.1. Primary Loan – Financial risks for SIG	11
3.1.2. Subsidiary Loan – Financial risks for SIG	11
3.1.2.1. Credit risk	11
3.1.3. On-lending arrangement – Financial risks for SIG.....	11
3.1.3.1. Foreign exchange mismatch risk.....	11
3.1.3.2. Interest rate risk.....	12
3.1.3.3. Tenor mismatch risk.....	12
3.1.3.4. Prepayment risk	12
3.1.3.5. Investment risk.....	12
3.1.3.6. Revenue risk.....	12
3.2. Financial risks for Beneficiary.....	13

3.2.1.	Subsidiary Loan – Financial risks for Beneficiary	13
3.2.2.	On-lending arrangement – Financial risks for Beneficiary	13
3.3.	Non-financial risks for SIG and beneficiaries	13
3.3.1.	Operational risk.....	13
3.3.2.	Legal risk.....	13
3.3.3.	Reputational risk	13
3.3.4.	Creditor concentration risk	14
4.	ELIGIBILITY FOR ON-LENDING ARRANGEMENT	15
4.1.	Primary lenders.....	15
4.2.	Beneficiary eligibility	15
4.3.	Project eligibility	15
4.3.1.	Sub-national entity projects.....	15
4.3.2.	Private company projects	16
4.3.3.	Commercial like characteristics	16
4.4.	Ineligible uses of on-lend funds	17
5.	PROPOSAL EVALUATION	18
5.1.	Evaluating proposed on-lending arrangements	18
5.1.1.	On-lending Evaluation Guidelines.....	18
5.1.2.	Principle of aligning to Development Budget process.....	18
6.	GUIDANCE ON ACCEPTABLE ON-LENDING ARRANGEMENT TERMS	19
6.1.	Acceptable PLA terms	19
6.2.	Acceptable SLA terms	19
6.2.1.	Denominated currency	19
6.2.2.	Tenor.....	19
6.2.3.	Grace period.....	19
6.2.4.	Payment schedule.....	20
6.2.5.	Subordination.....	20
6.2.6.	Interest rate – Fixed or floating	20
6.2.7.	Interest rate – Setting a SLA fixed rate	21
6.2.7.1.	SLA fixed interest rate formula	21
6.2.7.2.	PLA interest rate.....	21
6.2.7.3.	SIG administrative margin.....	21

6.2.7.4.	SIG FX margin	21
6.2.7.5.	SIG credit margin.....	22
6.2.7.6.	SIG interest rate subsidy	22
6.3.	SLA fixed interest rate conventions	22
7.	SLA ADMINISTRATIVE CONSIDERATIONS.....	23
7.1.	Disbursement.....	23
7.2.	Reporting.....	23
7.3.	Default.....	23
8.	RECOGNITION AND REPORTING ON-LENDING ARRANGEMENTS.....	25
8.1.	Recognition and reporting as Government borrowing (PLA)	25
8.2.	Recognition and reporting as asset (SLA)	25
8.3.	Counting against the Annual Borrowing Limit (ABL).....	25
9.	PAYMENT ARRANGEMENTS AND LOAN ADMINISTRATION	26
9.1.	Recording on-lending arrangements	26
9.2.	Disbursement of funds to Beneficiary	26
9.3.	Financial management of project expenditure related to on-lending arrangements.....	26
9.4.	CBSI accounts designated to SLAs.....	27
9.5.	Administration of SLAs.....	27
10.	BUDGETING FOR ON-LENDING ARRANGEMENTS.....	28

ABBREVIATIONS

ABL	Annual Borrowing Limit
ADB	Asian Development Bank
CBSI	Central Bank Solomon Islands
CS-DRMS	Commonwealth Secretariat Debt Recording and Management System
CSO	Community Service Obligation
DMAC	Debt Management Advisory Committee
DMF	Debt Management Framework
DMS	Debt Management Strategy
DMU	Debt Management Unit
ERU	Economic Reform Unit
FEDU	Financial Economic Development 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
PLA	Primary Loan Agreement
SIG	Solomon Islands Government
SLA	Subsidiary Loan Agreement
SOE	State Owned Enterprise
SCO	Statement of Corporate Objectives
WB	World Bank

EXECUTIVE SUMMARY

An on-lending arrangement is where the Solomon Islands Government (SIG) obtains a loan (usually concessional financing from an International Financial Institution (IFI) such as the World Bank (WB) or Asian Development Bank (ADB)) and then passes on the loan principal to another entity (usually a State Owned Enterprise (SOE)), known as the *Beneficiary*. The loan between SIG and the IFI is called the *Primary Loan* and the on-lend loan between SIG and the Beneficiary is called the *Subsidiary Loan*.

On-lending is a means by which SIG can support strategically important projects that aid national development. Consistent with the Debt Management Strategy (DMS), SIG will not enter into on-lending arrangements if the Primary Loan proceeds are earmarked to fund recurrent expenditure.

This Policy is one component of the Solomon Islands Debt Management Framework (DMF) (refer to section 3.2 of the DMS). Consistent with the legal provisions contained in the Public Financial Management Act (PFMA) 2013, all on-lending proposals need to be evaluated by the Debt Management Advisory Committee (DMAC), which pursuant to evaluation, is required to make a recommendation to the Minister of Finance on whether to authorise.

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 on-lending to sub-national entities (e.g. SOEs and provincial Governments) and private companies, which will be considered on an exceptions basis only.

Consistent with the SOE Act 2007, this Policy seeks to encourage SOEs to operate profitable and efficient businesses, whilst taking competitive neutrality considerations into account where relevant. As a benchmark, Subsidiary Loan terms should be broadly commensurate with commercial like loan terms for similar beneficiaries and projects. In certain circumstances, where it can be identified that a project will deliver a broader economic return to the Solomon Islands, an interest rate subsidy will generally be incorporated into a Subsidiary Loan, thereby making it a cheaper source of finance than a commercial loan.

Only in exceptional circumstances will SIG lend to SOEs or other entities that are not currently creditworthy. Further, SIG will only lend for projects that have net projected cash flows sufficient to make scheduled debt repayments and contribute to the future capital requirements of the entity.

1. INTRODUCTION

1.1. Definition of on-lending

An on-lending arises when the Solomon Islands Government (SIG) obtains a loan (*Primary Loan*) from a lending institution, for which it is legally bound to repay to that institution, and on-lends the loan principal (*Subsidiary Loan*) to another entity (*Beneficiary*), for example a sub-national entity (e.g. State Owned Enterprise (SOE) or provincial Government), which in turn is obligated to repay the principal with interest to SIG.

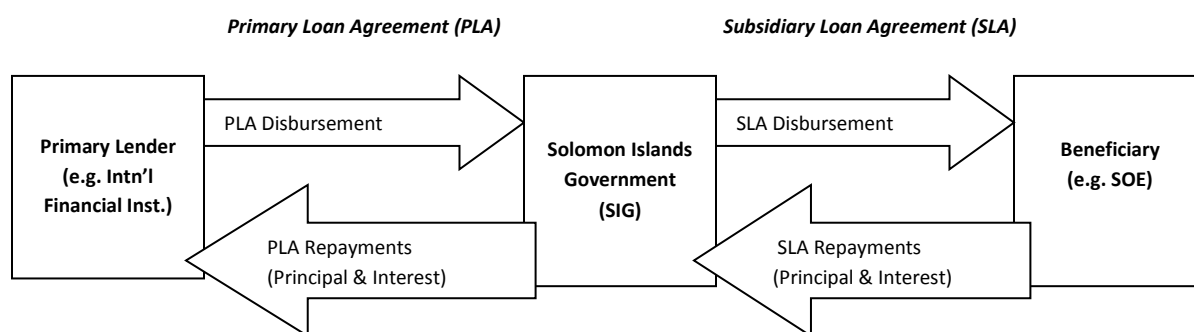
On-lending can also arise when SIG obtains grant funding from a lender/donor, which it then on-lends to a Beneficiary by way of a Subsidiary Loan, requiring that Beneficiary to repay the principal of the Subsidiary Loan.

Note that if SIG receives a grant from an International Financial Institution (IFI) and then ‘on-grants’ these funds to a Beneficiary without requiring that Beneficiary to repay the amount, then this is considered to be an on-grant, not an on-lend. An on-grant will only be considered under this Policy where a proposal intends to package up an on-grant with an on-lend.

1.2. How does on-lending work?

SIG would sign a Primary Loan Agreement (PLA) with a Primary Lender and a Subsidiary Loan Agreement (SLA) with a Beneficiary. SIG receives funds (disbursements of principal) from the Primary Lender which it then passes on to the Beneficiary. SIG is obligated to repay principal to the Primary Lender and pay any interest or fees as agreed under the PLA. The Beneficiary is then obligated to make repayments of principal and payments of interest to SIG as agreed under the SLA (Refer to Figure 1 below).

FIGURE 1: THE ON-LENDING ARRANGEMENT



The Primary Lender is usually an IFI that provides concessional finance (i.e. long grace periods¹, long repayment periods and low interest rates) intended for development projects, which is usually denominated in foreign currency.

¹Grace period is the time given by IFIs such as the WB and ADB (currently ten or eight years respectively) before principal repayments are required.

1.3. Why do on-lending in the Solomon Islands?

SIG, as a sovereign, is able to access concessional funding from Primary Lenders that are multilateral IFIs such as the World Bank (WB) or Asian Development Bank (ADB). The IFIs do not make this concessional funding available directly to non-sovereign entities. The IFIs do however make concessional funding available indirectly to non-sovereigns such as SOEs via on-lending arrangements.

The terms and conditions of PLAs are typically different to those included in SLAs. Interest rates for instance are usually higher in SLAs than in PLAs, but the rate is generally lower than what the Beneficiary could otherwise borrow at from commercial lenders. On-lending can therefore facilitate the delivery of development projects that are expected to provide a net economic return to the Solomon Islands.

1.4. PFMA legal provisions relating to on-lending arrangements

Refer to section 3.2.1.1 of the Debt Management Strategy (DMS) for a summary of legal provisions included in the Public Financial Management Act (PFMA) 2013 that relate to on-lending arrangements. Two key statutory provisions are outlined below.

1.4.1. Ministerial authorisation

The PFMA requires all on-lending arrangements to be authorised by the Minister of Finance (refer to section 3.2.1.1.4 of the DMS).

1.4.2. Debt Management Advisory Committee (DMAC) evaluation

Before making a decision on whether to authorise an on-lending arrangement, 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 on-lending arrangement proposal in order to provide a properly informed recommendation to the Minister of Finance.

1.5. Scope of this Policy

The scope of this Policy is to provide evaluation and decision making guidance for prospective beneficiaries, prospective primary lenders, the 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 on-lending.

Note that this Policy does not provide guidance on whether grant funding provided to SIG should be on-lent, as opposed to on-granted, to a Beneficiary. This Policy does however provide evaluation and decision making guidance if a proposal proposes that either an on-lending of grant funds or an on-grant is to be packaged up with an on-lend.

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 on-lending are not repeated in this Policy.

1.5.1. Policy rationale for on-lending grant funds received by SIG

Policy rationale for on-lending grant funds received by SIG to Beneficiaries should be formulated by the Economic Reform Unit (ERU) and the Financial Economic Development Unit (FEDU) on a case by case

basis. If it is deemed appropriate to on-lend grant funds received by SIG, then this Policy may be used to guide the structure of the on-lending arrangement.

1.5.2. Non-permissible on-lending arrangements

Refer to section 8.2 of the DMS. Although the PFMA defines on-lending arrangements, whereby a SOE or Provincial Government is a debtor of a Primary Loan and creditor of a Subsidiary Loan, as Government borrowing, sub-national entities are not permitted to enter into such on-lending arrangements under the DMF.

1.6. 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 on-lending arrangements (refer to section 3.2.1.1 of the DMS);
2. provide clarity to entities that are contemplating entering into an on-lending arrangement with SIG on how to meet their legal obligations under the PFMA;
3. provide operational clarity to the DMAC Secretariat on how to evaluate on-lending arrangement proposals; and
4. provide clarity to DMAC and entities that are contemplating entering into an on-lending arrangement with SIG on the evaluation process for proposed on-lending arrangements (this policy is to be read in conjunction with the ***On-lending Evaluation Guidelines***).

Secondary objectives of this Policy are to promote:

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

1.7. Administration of this Policy

The DMU, in collaboration with the ERU, will be responsible for administering this Policy.

1.8. 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 beneficiaries with respect to on-lending arrangements; and
- performance of SOEs with respect to their borrowing from commercial sources.

It shall also be reviewed in light of any changes in Government policy relating to SOEs, such as funding of SOEs through Community Service Obligations (CSOs) or payment of dividends to SIG by SOEs.

2. GENERAL PRINCIPLE OF THIS ON-LENDING POLICY

On-lending at commercial-like interest rates for projects, through SLAs, encourages beneficiaries to operate efficiently, promotes efficient resource allocation within the economy² and discourages beneficiaries from pursuing projects with low rates of return.

It upholds the principle of competitive neutrality by ensuring that beneficiaries do not receive an unfair advantage over private sector firms when they are engaged in direct competition. It also ensures that private companies do not receive an unfair advantage over other companies or business sectors. It should however be noted that there is limited scope for competitive neutrality concerns to be realised in the Solomon Islands given the lack of competition in the sectors within which potential on-lending arrangement beneficiaries operate in.

There may however be instances where it is appropriate for Governments to on-lend at an interest rate that is less than the prevailing commercial rate. This might be reasonable and beneficial if it can be demonstrated that a project, which is to be funded through an on-lending arrangement, is expected to provide a net economic return (refer to Appendix 3 of the DMS) to the country and if the extent of the interest rate subsidy is explicitly stated.

²ADB (2011) *Finding Balance: Benchmarking the Performance of State-Owned Enterprises in Fiji, Marshall Islands, Samoa, Solomon Islands, and Tonga*. ADB.

3. RISKS ASSOCIATED WITH ON-LENDING

3.1. Financial risks for SIG

Financial risk refers to the potential for adverse financial outcomes that can be attributed to changes in financial variables (e.g. interest rates, foreign exchange rates etc). SIG can potentially be exposed to financial risks on a PLA, SLA or on-lending arrangement.

The types of financial risk exposures that need to be considered when an on-lending arrangement is being evaluated are summarised below by PLA, SLA and on-lending arrangement.

If SIG knows the quantum of its future debt servicing requirement payments and receipts on a financial arrangement, **with certainty**, then that arrangement exhibits no risk. Conversely, if SIG does not know, with certainty, the quantum of future cost (and revenue) outcomes, then those cost (and revenue) outcomes are subject to risk.

3.1.1. Primary Loan – Financial risks for SIG

SIG directly borrows on the Primary Loan in an on-lending arrangement. SIG's financial risk exposures on a direct borrowing are summarised in section 2.1 of the SIG Direct Borrowing Policy.

3.1.2. Subsidiary Loan – Financial risks for SIG

SIG is the lender on the Subsidiary Loan in an on-lending arrangement. SIG's financial risk exposures as a lender are summarised below.

3.1.2.1. Credit risk

Credit risk relates to the risk of financial loss arising from a counterparty to a transaction defaulting on its financial obligations under that transaction. Credit risk materialises if a default occurs and if the lender experiences a financial loss as a result of the default.

A Beneficiary default on a Subsidiary Loan can be caused by the materialisation of one or more of the risks referred to below in section 3.2 ('Subsidiary Loan – Financial risks for Beneficiary'). SIG's credit risk exposure on a Subsidiary Loan is therefore a function of these risks.

3.1.3. On-lending arrangement – Financial risks for SIG

SIG's financial risk exposures on an on-lending arrangement are a function of the combined characteristics of the Primary Loan and the Subsidiary Loan. These potential risks are summarised below.

3.1.3.1. Foreign exchange mismatch risk

This relates to an on-lending arrangement whereby SIG takes on foreign currency denominated debt from an IFI through a PLA but on-lends via a SLA in SBD. With such an arrangement, SIG's SBD debt service requirement payments are subject to change depending on foreign exchange movements, but SIG's receipts are fixed in SBD. There is therefore scope, depending on changes in SBD foreign exchange rates, for the SBD value of debt service requirement payments related to the PLA to become larger than the SBD value of the receipts related to the SLA.

3.1.3.2. Interest rate risk

This relates to an on-lending arrangement whereby SIG takes on fixed-rate debt from an IFI through a PLA but on-lends floating-rate debt via the SLA. With such an arrangement, SIG's interest cost of debt is known for the life of the PLA, but interest revenue receipts are subject to change depending on movements in the reference rate stipulated in the SLA. There is therefore scope, depending on changes in the reference rate, for the value of SIG's interest cost on the PLA to be greater than the interest revenue receipts on the SLA over the life of the on-lending arrangement.

3.1.3.3. Tenor mismatch risk

This relates to an on-lending arrangement where there is a mismatch between the tenor of the PLA and the SLA. Consistent with the DMS, SIG will seek out Primary Loans with concessional financing terms from IFIs. These loans are characterised by long tenors, usually between 30 and 40 years. Development projects, however, for which Subsidiary Loan funds are to be used, will most likely have project time profiles of less than 30 to 40 years. There is therefore scope in on-lending arrangements for SIG to be exposed to a period of time where SIG might be obligated to make debt service requirement payments to an IFI on the PLA, but is not in receipt of debt service cost payments from the Beneficiary on the SLA.

3.1.3.4. Prepayment risk

In the event that there is a tenor mismatch between a PLA and SLA, SIG will most likely receive the Subsidiary Loan principal prior to being required to repay the Primary Loan principal. In theory, the Subsidiary Loan principal receipts should be used by SIG to prepay Primary Loan principal ahead of schedule. It is however not uncommon for early repayments of principal to be precluded by PLAs. In such circumstances, SIG will be the custodian of a build-up in cash, intended for the repayment of Primary Loan principal. Should Primary Loan principal prepayments be precluded, then there is a risk around how the build-up of cash is managed.

3.1.3.5. Investment risk

In the event that prepayment risk arises because of a tenor mismatch between a PLA and SLA, one option for SIG is to invest the build-up of cash with a view to use investment proceeds to repay Primary Loan debt service requirement payments as and when they fall due. Should a policy decision be made to invest the build-up of cash, SIG will be exposed to investment risk. Further, SIG would need to establish Investment Guidelines/Policy to manage investment risk and the investment process more generally. Investment risk encapsulates the array of risk exposures (credit, liquidity, interest rate, market and operational risk) that apply when investing.

3.1.3.6. Revenue risk

In the event that prepayment risk arises because of a tenor mismatch between a PLA and SLA, another option for SIG is to use the build-up of cash to fund budget expenditure. Should this option be selected, there is a risk around how the funds are used. For instance, the funds could be used to fund: 1) a new loan from SIG to an SOE; and/or 2) grants for capital expenditure; and or 3) recurrent expenditure. Clearly, if a build-up of cash is used to fund grants or recurrent expenditure, then SIG may not be able to generate enough future revenue to repay part of, or all of the Primary Loan principal (refer to section 7.1.1 of the DMS). Should this be the case, SIG's repayment risk exposure on the Primary Loan increases.

3.2. Financial risks for Beneficiary

Financial risk refers to the potential for adverse financial outcomes that can be attributed to changes in financial variables (e.g. interest rates, foreign exchange rates etc). An on-lending Beneficiary needs to consider its financial risk exposures on a proposed SLA.

3.2.1. Subsidiary Loan – Financial risks for Beneficiary

A Beneficiary effectively directly borrows on a Subsidiary Loan. A Beneficiary's financial risk exposures on direct borrowing are summarised in section 3.1 of the Sub-national Direct Borrowing Policy.

3.2.2. On-lending arrangement – Financial risks for Beneficiary

There are no financial risks specific to an on-lending arrangement that a Beneficiary needs to consider when contemplating an on-lending arrangement.

3.3. Non-financial risks for SIG and beneficiaries

Non-financial risk refers to the potential for variability in cost outcomes, or financial losses, which can be attributed to failures in the management of a debt obligation, or a portfolio of obligations. The types of non-financial risk exposures that need to be considered by both SIG and a Beneficiary when evaluating an on-lending arrangement are summarised below.

Combined, these non-financial risks can be contributing factors to a default on the SLA by a Beneficiary.

3.3.1. Operational risk

Operational risk refers to the potential for financial loss that may result from inadequate or failed internal processes, systems, people, or external non-financial events. Both SIG and the Beneficiary need to be cognisant of operational risk with respect to on-lending arrangements.

By way of example, sources of operational risk could be an inadequate:

- reconciliation process resulting in an overpayment on a loan; or
- payments process that results in a default on a debt service requirement payment; or
- legal review process resulting in unfavourable clauses being included in a legal agreement.

3.3.2. Legal risk

Legal risk arises from the potential that lawsuits, unenforceable agreements or adverse judgments can disrupt or otherwise negatively impact on the operations or conditions of an entity and cause financial loss. Both SIG and the Beneficiary need to be cognisant of legal risk with respect to on-lending arrangements.

3.3.3. Reputational risk

Reputational risk refers to the damage that can be caused to an entity's reputation due to previous actions or inactions. Reputational damage can adversely impact on a borrower's future borrowing costs and it can also compromise an entity's capacity to influence and positively interact with stakeholders. Both SIG and the Beneficiary need to be cognisant of reputational risk with respect to on-lending arrangements.

3.3.4. Creditor concentration risk

Creditor concentration risk relates to the prospect that any one creditor can have undue influence over an entity because they are the counterparty to a proportionately large amount of the entity's total borrowing. Both SIG and the Beneficiary need to be cognisant of creditor concentration risk with respect to on-lending arrangements.

4. ELIGIBILITY FOR ON-LENDING ARRANGEMENT

4.1. Primary lenders

The Minister **will only** consider authorising PLAs with primary lenders that offer concessional financing in compliance with section 5 (Guidance on acceptable SIG direct borrowing terms) of the SIG Direct Borrowing Policy.

4.2. Beneficiary eligibility

The Minister **will only** consider authorising SLAs with:

- 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 companies that;
 - are credit worthy;
 - have no formal debt arrears;
 - have no NPF contribution arrears; and
 - have no tax arrears.

On-lending arrangements **will not** be entered into with:

- 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.

4.3. Project eligibility

4.3.1. Sub-national entity projects

Eligible projects for on-lending to sub-national entities

The Minister **will only** consider authorising a SLA with a sub-national entity if the proceeds of the borrowing are to be used to finance a project that:

- complies with sections 8.13 and 8.14 of the DMS; and
- has previously been included by the SOE in a SCO provided to the MoFT (N.B. This only applies to SOE proposed on-lending arrangements); and

- **exhibits** commercial like characteristics (refer to part 4.3.3 of this Policy); 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 for on-lending to sub-national entities (but possibly eligible for SIG grants)

The Minister **will not** authorise a SLA with a sub-national entity if the proceeds of the borrowing are to be used to finance a project that:

- complies with sections 8.13 and 8.14 of the DMS; but
- **does not exhibit** any commercial like characteristics (refer to part 4.3.3 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 for an on-lending arrangement, as per the criteria listed above, the Government could consider funding (in full or in part) the project either through the development Budget or with an on-grant arrangement.

4.3.2. Private company projects

Eligible projects for on-lending

A private company project is eligible to be funded (in full or in part), through an on-lending arrangement, in exceptional circumstances, if the project:

- has been identified in the National Development Strategy (NDS) and National Infrastructure Investment Plan (NIIP) as being of national strategic importance;
- **does not exhibit only** commercial characteristics (refer to part 4.3.3 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.

4.3.3. 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.

4.4. Ineligible uses of on-lend funds

SIG will not enter into an on-lending arrangement if the intended use of the SLA funds is 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 on-lending arrangements

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

The Beneficiary of an on-lending arrangement must comply with the evaluation process outlined in the On-lending Evaluation Guidelines if it wishes to seek ministerial authorisation for an on-lending arrangement.

5.1.1. On-lending Evaluation Guidelines

This Policy should be read by stakeholders (e.g. prospective beneficiaries and Primary Loan lenders) in conjunction with the On-lending Evaluation Guidelines.

Those Guidelines outline the process to be followed by all stakeholders for the evaluation of on-lending arrangement proposals.

They also 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 on-lending arrangements 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 NDS, 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 ON-LENDING ARRANGEMENT TERMS

6.1. Acceptable PLA terms

Refer to section 5 (Guidance on acceptable SIG direct borrowing terms) of the SIG Direct Borrowing Policy for acceptable PLA terms.

6.2. Acceptable SLA terms

6.2.1. Denominated currency

Key point: *SLA's should predominantly be denominated in SBD. Where this is the case, SIG will bear the foreign exchange risk on the PLA (if the PLA is denominated in a foreign currency). The SLA may be foreign currency denominated, in exceptional circumstances, where it can be demonstrated that a prospective Beneficiary has the capacity to manage foreign exchange rate risk.*

Increasing a Beneficiary's foreign exchange risk exposure may have the effect of increasing SIG's credit risk exposure to the Beneficiary. A Beneficiary will be deemed to exhibit adequate capacity to manage foreign exchange risk if it can clearly identify a hedging plan to mitigate the risk. The hedging plan may include financial instrument hedges and/or disclosure of natural hedges that are intrinsic to the Beneficiary's balance sheet (e.g. foreign currency denominated revenue generated by the balance sheet).

Generally, central Governments have larger and more diverse balance sheets than SOEs and Provincial Governments. This implies a more diverse source of revenue for central Governments, which means they are generally in a better position to manage foreign exchange rate risk exposures than beneficiaries.

6.2.2. Tenor

Key point: *The repayment period for a SLA will depend on two factors, being the terms of the PLA and the cash flows of the project.*

Principal repayments to SIG from the Beneficiary should begin in the year that the project is expected to be operational and realizing sufficient cash flow to make repayments. Principal repayments shall be made over a period: 1) not exceeding the Primary Loan; and 2) in line with the expected economic life of the project.

The principle of inter-generational equity needs to be upheld so that future generations are not making repayments on projects from which they are no longer receiving any direct benefit. SLA repayment periods should therefore be shorter than what is included in the PLA: IFI's lending terms are standardized and typically include tenors of between 30 to 40 years. Under these circumstances, repayments from the Beneficiary to SIG under the SLA will begin and end sooner than those from SIG to the Primary Lender under the PLA.

6.2.3. Grace period

Key point: *Any grace period provided in a SLA should not be longer than that provided in the PLA and will be for principal repayments only.*

Any grace period included in a SLA will not be longer than that included in the PLA. Under concessional loans, grace periods usually apply to principal only. Interest and/or fees are usually payable by SIG during the grace periods. SLAs will therefore require the Beneficiary to make interest repayments during any grace period because SIG has to administer and service the loan during this time.

It is also important to establish a pattern of payment for the Beneficiary from the outset. Otherwise it is easy for the entity to ‘forget’ responsibility for repayment or for future governments to have a different attitude towards repayments.

6.2.4. Payment schedule

Key point: *The payment schedule will be based on the following:*

- Principal and interest payments should be semi-annual.
- Principal and interest payment dates of the SLA should be aligned with the payment schedule included in the PLA.
- Principal should be repaid in equal instalments on each repayment date.
- Principal repayments should begin in the year (i.e. grace period ends) that the project is expected to be operational and realizing cash flows sufficient to make repayments.
- The number of total payment dates should not generally exceed 40 (i.e. the SLA will have a maximum tenor of 20 years).
- Billing statements for payment dates will be issued to the Beneficiary such that funds are received by SIG in time to make payments to the Primary Lender.

6.2.5. Subordination

Key point: *In the event that SIG is subordinated to another lender under a SLA, then the interest rate charged on the SLA should be adjusted to compensate SIG for the subordination.*

Where a project is being part funded with commercial loans, the commercial lender(s) will often demand that the sovereign lender (i.e. SIG) be fully subordinated³ to the commercial lender(s). SIG bears substantially more risk under a subordinated structure than in a non-subordinated structure. SIG will account for any subordination arrangements through the setting of the interest rate on the SLA.

6.2.6. Interest rate – Fixed or floating

Key point: *SLA's should predominantly be fixed-rate loans. SIG will consider floating-rate loans in exceptional circumstances if the Beneficiary can provide a strong business case for the use of a floating rate.*

Floating-rate loans are riskier than fixed-rate loans because of the uncertainty around the level of future interest rates. Compared with a fixed-rate loan, a floating-rate loan increases the debtor's (i.e. the Beneficiary of a SLA) repayment risk exposure as they are susceptible to large increases in the reference

³Subordinated debt is repaid after taxes and senior debt in case of liquidation due to bankruptcy.

interest rate. The creditor (i.e. SIG in a SLA) is exposed to increased credit risk because the debtor may not be able to manage and/or meet repayments in the event of an increase in reference interest rates.

6.2.7. Interest rate – Setting a SLA fixed rate

Key point: *The SLA fixed interest rate for SLAs will be determined by taking into account:*

- *SIG's administrative cost of managing on-lending arrangements;*
- *the foreign exchange risk borne by SIG on the on-lending arrangement;*
- *the credit risk borne by SIG on the on-lending arrangement; and*
- *the interest rate subsidy provided by SIG on the on-lending arrangement.*

The SLA interest rate is therefore calculated using the formulae below.

6.2.7.1. SLA fixed interest rate formula

FIGURE 2: THE SLA FIXED RATE FORMULA

<i>SLA</i> <i>fixed interest</i> <i>rate</i>	=	<i>PLA</i> <i>interest rate</i>	+	<i>SIG</i> <i>administrative</i> <i>margin</i>	+	<i>SIG</i> <i>FX margin</i>	+	<i>SIG</i> <i>credit margin</i>	-	<i>SIG</i> <i>interest rate</i> <i>subsidy</i>
--	---	------------------------------------	---	--	---	--------------------------------	---	------------------------------------	---	--

Each component of the formula is described below.

6.2.7.2. PLA interest rate

This will be equivalent to the interest rate charged by the Primary Lender on a PLA, inclusive of any other fees, including service fees, commitments fees etc.

PLA interest rate = all interest, charges and fees charged under a PLA

6.2.7.3. SIG administrative margin

SIG will incur operational costs when administering on-lending arrangements. These costs relate to, for example, the handling of disbursements, receiving and making repayments, monitoring and reporting. Therefore, SIG will typically charge an administrative margin of between 0.1% and 0.5% p.a. on all SLAs depending on the complexity of administering the on-lending arrangement.

SIG administrative margin = 0.1% - 0.5%

6.2.7.4. SIG FX margin

The SIG FX margin will be based on the; 1) historical volatilities of the denominated currency or currencies of the PLA; 2) tenor of the PLA; 3) prevailing FX Policy regime administered by the Central Bank of Solomon Islands⁴ (CBSI); and 4) perceived risks of a prolonged devaluation of the SBD.

⁴ At present, CBSI pegs the SBD to a trade weighted basket of currencies, with an acceptable band of ±1 percent around the base parity of the bilateral SI\$/US\$ exchange rate.

In the event that a PLA is denominated in multiple foreign currencies, the historical volatility of each currency will be assessed and considered.

The SIG FX margin will be 0% if, in exceptional situations, the denominated currency, tenor and principal repayment schedule matches the PLA.

6.2.7.5. *SIG credit margin*

The SIG credit margin will be based on the results of the 'entity credit risk assessment' performed by the DMU as part of the 'proposal assessment' (refer to the Guidelines) and the extent to which a Subsidiary Loan might be subordinated to co-financiers of the project.

Upon completion of the entity credit risk assessment, the DMU will assign the entity with a credit rating that will characterise SIG's credit exposure to the entity. The possible credit ratings are:

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

An appropriate SIG credit margin will be set commensurate with the entity credit rating, the tenor of the SLA and the extent to which a Subsidiary Loan might be subordinated to co-financiers of the project.

6.2.7.6. *SIG interest rate subsidy*

The SIG interest rate subsidy will be based on the assessment of a project's capacity to generate a 'net economic return' (refer to Appendix 3 of the DMS) for the Solomon Islands. Each project will be assigned a rating that characterises the project's capacity to generate a net economic return.

Only project's that are assessed to provide a net economic return will be eligible for a SIG interest rate subsidy. A project's expected capacity to generate a net economic return be rated as being either:

1. no benefit;
2. small;
3. moderate; or
4. large.

An appropriate SIG interest rate subsidy will be set commensurate with the project's net economic return rating.

6.3. **SLA fixed interest rate conventions**

Key point: *The interest payable on a SLA shall be calculated:*

- Using an annual rate of interest;
- On the total amortising principal loan amount outstanding;
- On a semi-annual basis, consistent with the interest payment dates shown in the SLA payment schedule; and
- On the basis of actual number of days elapsed on a year of 365 days.

7. SLA ADMINISTRATIVE CONSIDERATIONS

7.1. Disbursement

Disbursement procedures need to be agreed with the Primary Lender before the PLA is signed. These procedures should place strict controls around disbursements to ensure that disbursements are only made to finance expenditure on the project scope that has been agreed between SIG, the Beneficiary and the PLA lender.

Furthermore, the PFMA requires any funds borrowed by SIG to be paid into the Consolidated Fund. Disbursements that are paid into either: 1) a bank account held with the lender that is in the name of SIG; or 2) an account held with CBSI in the name of SIG, will satisfy the requirement for borrowed funds to be paid into the Consolidated Fund.

7.2. Reporting

SIG must include Beneficiary reporting requirements in the SLA. This will assist SIG to monitor the project and the financial health of the Beneficiary. By way of example, SIG could require an SOE to meet its reporting obligations under MoFT's SCO framework. The Primary Lender may also have their own reporting requirements for the Beneficiary that SIG should be cognisant of when setting SLA Beneficiary reporting requirements.

7.3. Default

Key Point: *A penalty interest rate should be levied over and above the SLA fixed interest rate and will apply in the event that the Beneficiary is deemed to have defaulted on the SLA – this rate should be set in the SLA.*

- *A penal interest rate of between 1.0% – 3.0% p.a. should be applied as a penalty rate in the event of default.*

Potential Beneficiaries should identify and agree on a plan outlining how SIG will recover losses in the event of default on a SLA. This must be credible, but not include the option of nationalization (or any other variation on SIG running the business to make good losses).

Default will be deemed to occur if the Beneficiary fails to pay as per the payment schedule or perform project requirement (as outlined in the Project Agreement, for example). In loan documents this condition may also be referred to as 'accelerated maturity' (for example, by ADB).

The SLA should specify that if a default occurs before project completion, then SIG no longer has the obligation to disburse the remainder of the principal loan amount.

The consequences of default are serious and therefore SIG needs to prevent situations that lead to default. The SLA must strike a balance between: 1) imposing penalties that create incentives for the Beneficiary to honour the SLA terms and conditions; and 2) providing the Beneficiary with sufficient time or opportunity to remedy or rectify a default.

There are likely to be different risks and recourses depending on whether SLA funds have already been disbursed. Liquidation or transfer of assets used as security may be possible for a private company whereas neither is likely to be effective for an SOE.

SIG also needs to consider what happens to the project if the Beneficiary defaults. In the case of SOEs, SIG will not only be held responsible for repaying the loan but might 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 SLA negotiation phase.

Procedurally, as a first step to dealing with a default, DMU will **immediately** notify the Beneficiary demanding immediate payment. The PS Finance will write to the Beneficiary demanding immediate payment. Correspondence should also outline the penal interest rate applicable, the grace period (if any) and the consequences of failure to rectify the default by a prescribed time. If the default is not rectified, the Minister of Finance will write to the head of the Beneficiary to demand immediate payment of the due amount, seek an explanation of the default and outline punitive measures that will apply should the default not be rectified.

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

- applying the default clauses contained in the SLA;
- listing the entity on a publicly available list of defaulting entities, posted on the MoFT website;
- informing Cabinet that the entity is in default; and/or
- deeming the entity ineligible for future on-lending arrangements.

For private companies in default, the default clauses in the SLA will apply. These clauses should provide for the transfer of assets to SIG that have been used by the company as collateral for the SLA.

In cases where the Beneficiary provides sufficient evidence that it is genuinely unable to service the loan, it may be preferable to restructure the loan. Where a restructure occurs, it is important that records are kept on the nature of the restructure and a new deed is drafted. Past experience has shown that there have been differences of opinion about what was agreed to (whether debt forgiveness, equity injection, or loan restructure) because of poor agreements and record keeping.

- Where SIG is not the only lender, it needs to negotiate its position in the case of default. If SIG is subordinated to other lenders, failure to pay SIG may not initiate a default under common terms and conditions.

8. RECOGNITION AND REPORTING ON-LENDING ARRANGEMENTS

8.1. Recognition and reporting as Government borrowing (PLA)

All PLA obligations shall be recognised and reported, on a 100% of face/notional value basis, as Government borrowing in accordance with sections 8.5 and 8.6 of the DMS.

8.2. Recognition and reporting as asset (SLA)

All Subsidiary Loans will be recognised by SIG as financial assets and will be reported as such.

8.3. Counting against the Annual Borrowing Limit (ABL)

All PLA obligations shall be recognised against the ABL year in which the borrowing has been recognised as a Government borrowing in accordance with section 8.5 of the DMS.

The SLA will not be recognised against the ABL year in which the SLA has been signed because the Subsidiary Loan is effectively a SIG asset.

9. PAYMENT ARRANGEMENTS AND LOAN ADMINISTRATION

9.1. Recording on-lending arrangements

The DMU will maintain a database using the Commonwealth Secretariat Debt Recording System (CS-DRMS) to record all the details of both PLAs and SLAs. Loan agreements will be stored in a safe place both as hard copies and as scanned soft copies.

9.2. Disbursement of funds to Beneficiary

IFIs typically formalise PLAs by way of Financing Agreements. It is standard process for IFIs to deposit, once a Financing Agreement becomes ‘effective’⁵, the stipulated Primary Loan amount into a ‘Loan Account’ held with the IFI and in the borrowers name.

For a Beneficiary to access a Subsidiary Loan amount, the money needs to, in the first instance, be withdrawn/disbursed on the Primary Loan. Once this occurs, the funds are then effectively available for a Beneficiary to expend on the agreed scope of a project.

IFIs impose standardised withdrawal/disbursements procedures on borrowers. The IFIs typically offer the following withdrawal/disbursement methods: 1) advance to Beneficiary; 2) re-imburement of Beneficiary; and 3) direct payment to project suppliers (N.B. each IFI might call each method a different name).

To action either withdrawal/disbursement method, the IFIs require a ‘withdrawal application’ to be submitted. These withdrawal applications need to be signed by persons that have been nominated as ‘authorised signatories’ by the borrower (Minister of Finance in the case of Solomon Islands).

As part of the process to achieve loan effectiveness, the borrower needs to provide IFIs with a letter nominating authorised signatories for withdrawal applications. ***It is a requirement of this Policy*** that the letter:

1. includes two categories of signatories, one comprising of:
 - a) the Beneficiary’s authorised borrowing representatives; and
 - b) MoFT accountable and accounting officers (as defined in the PFMA).
2. requires withdrawal applications to be signed by two authorised signatories, one having to be from one category, and one having to be from the other category.

9.3. Financial management of project expenditure related to on-lending arrangements

Financial management controls around project expenditure related to on-lending arrangements are:

1. IFI financial management controls (all project expenditure needs to be acquitted to the IFIs); and

⁵ Each Financing Agreement entered into with an IFI includes a set of requirements that need to be met for the Financing Agreement to become effective (e.g. Legal vetting by the Solomon Islands Attorney Generals Chambers).

2. the requirement for a MoFT accountable or accounting officer to sign Primary Loan withdrawal applications.

9.4. CBSI accounts designated to SLAs

The DMU should setup a designated account for each SLA that SIG enters into. These accounts should be used to:

- receiving Subsidiary Loan debt servicing requirement payments from beneficiaries;
- deposit funds into the Government's Debt Servicing Account, held with CBSI, for the purpose of discharging debt obligations with Primary Lenders.

9.5. Administration of SLAs

The DMU will be responsible for administering each SLA that SIG enters into. The DMU should develop processes to perform the following administrative functions:

- SLA billing to beneficiaries;
- SLA debt servicing requirement payment receipting and reconciliation; and
- Beneficiary liaison.

10. BUDGETING FOR ON-LENDING ARRANGEMENTS

On-lending arrangements consist of many distinct monetary flows that need to be budgeted for in SIG's annual Budget. Please refer to Appendix 4 of the DMS for guidance on how to appropriate for each specific flow.