SOLOMON ISLANDS GOVERNMENT (SIG) DIRECT BORROWING POLICY

Solomon Islands Government

Approved by Minister of Finance

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SIG DIRECT BORROWING POLICY

Contents

ABBREVIATIONS

ABL	Annual Borrowing Limit
ADB	Asian Development Bank
ADF	Asian Development Fund
CBSI	Central Bank of Solomon Islands
CPA	Country Performance Assessment
CPIA	Country Policy and Institutional Assessments
DMAC	Debt Management Advisory Committee
DMF	Debt Management Framework
DMS	Debt Management Strategy
DMU	Debt Management Unit
DSC	Debt Service Cost
DSR	Debt Servicing Requirement
ERU	Economic Reform Unit
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
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
SDR	Special Drawing Rights
WB	World Bank

EXECUTIVE SUMMARY

Solomon Islands Government (SIG) direct borrowing occurs when the Government, through the Minister of Finance, contracts either domestic or foreign debt through loans or financial leasing.

SIG direct borrowing is usually undertaken to fund projects that are managed by a SIG agency/ministry (an 'Implementing Agency'). SIG direct borrowing can also be undertaken to facilitate on-lending arrangements (refer to SIG'S On-lending Policy for more information on on-lending arrangements).

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 Public Financial Management Act (PFMA) 2013, all SIG direct borrowing 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 the borrowing.

The current level of SIG direct borrowing is both sustainable and affordable. Looking forward, if incurred and managed properly, SIG direct borrowings can be utilised to improve the wellbeing of Solomon Islanders. Given the current level of debt, there is scope to undertake new SIG direct borrowing to fund much needed development in the Solomon Islands.

1. INTRODUCTION

1.1. What is SIG direct borrowing?

Solomon Islands Government (SIG) direct borrowing occurs when the Government, through the Minister of Finance, contracts domestic or foreign debt through loans or financial leasing.

SIG direct borrowing is usually undertaken to fund projects that are managed by a SIG agency/ministry (AN 'Implementing Agency'). These projects aim to create a net economic benefit (refer to Appendix 3 of SIG's Debt Management Strategy (DMS) for further information on net economic benefit) for the Solomon Islands. SIG direct borrowing can also be undertaken to facilitate on-lending arrangements (refer to SIG's On-lending Policy for more information on on-lending arrangements).

1.2. PFMA legal provisions relating to SIG direct borrowing

Refer to section 3.2.1.1 of the DMS for a summary of legal provisions included in the Public Financial Management Act (PFMA) 2013 that relate to SIG direct borrowing. Two key statutory provisions are outlined below.

1.2.1. Ministerial authorisation

The PFMA requires all SIG direct borrowing 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 SIG direct borrowing, 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 SIG direct borrowing 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 Implementing Agencies, 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 SIG direct borrowing.

SIG direct borrowing, for the purpose of this Policy, ***refers to any borrowing that has a tenor of greater than one year***, therefore excluding Treasury-Bill issuance.

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 are not repeated in this Policy.

1.4. Objectives of this Policy

<u>*Primary*</u> objectives of this Policy are to:

1. give operational effect to the legal provisions contained in the PFMA, which relate to SIG direct borrowing (refer to section 3.2.1.1 of the DMS);

2. provide clarity to prospective Implementing Agencies on how to meet their legal obligations under the PFMA;
3. provide operational clarity to the DMAC Secretariat on how to evaluate SIG direct borrowing proposals; and
4. provide clarity to prospective Implementing Agencies, lenders and the DMAC on the evaluation process for proposed SIG direct borrowing (N.B. this policy is to be read in conjunction with the ***SIG Direct Borrowing 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.

1.5. 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. It shall also be reviewed in light of any changes in Government policy relating to SIG direct borrowing.

2. RISKS ASSOCIATED WITH SIG DIRECT BORROWING

Risk refers to the potential for adverse outcomes that can be attributed to unexpected economic outcomes, changes in financial variables (e.g. interest rates and foreign exchange rates) and/or non-financial factors.

The risk exposures associated with SIG direct borrowing are summarised below at section 2.1 and onwards.

Materialisation of one, or a combination, of these risks can result in:

- adverse debt servicing requirement[1] (DSR) outcomes, which are undesirable **but** affordable, therefore **not** necessarily leading to a default by SIG; or
- adverse DSR outcomes, which are undesirable **and not** affordable, therefore **leading** to a default by SIG; or
- a default by SIG.

A default by SIG is undesirable because it can:

- restrict SIG's future access to sources of finance; and/or
- have negative cost implications for SIG (immediately or in the future).

2.1. Financial risks for SIG

Financial risk, with respect to SIG direct borrowing, refers to the potential for adverse variances in DSR outcomes that can be ***attributed to changes in financial variables*** (e.g. foreign exchange rates, interest rates etc).

If variances in SIG's DSR are unaffordable, SIG is likely to default on the respective direct borrowing obligation.

The types of financial risk exposures that need to be considered by SIG when considering a proposal to directly borrow, are summarised below.

2.1.1. Foreign exchange risk

The SBD value of DSR payments on foreign currency denominated debt is a function of the: 1) foreign currency denominated value of the payments; and 2) foreign exchange rate prevailing at the time the DSR payments are made. The DSR for an unhedged foreign currency denominated direct borrowing will increase if the SBD depreciates against the denominated currency over the life of the borrowing.

Foreign exchange risk refers to the potential for adverse outcomes in the SBD value of DSR payments, which have been caused by a change in exchange rates, on foreign currency denominated borrowings. There is no foreign exchange risk exposure on SBD denominated debt.

[1] Refer to section 5.1.3 of the Debt Management Strategy.

If unaffordable, adverse DSR outcomes, which have been caused by the materialisation of foreign exchange risk, are likely to cause a SIG default.

2.1.2. Interest rate risk

The debt service cost[2] (DSC) on variable/floating-rate debt is a function of the variable interest rate prevailing at the time interest payments are made. DSC payments on unhedged variable/floating-rate debt will increase when the debt's reference interest rate increases.

Interest rate risk refers to the potential for adverse outcomes in DSC payments, which have been caused by a change in the reference interest rate on variable/floating-rate debt. There is no interest rate risk exposure on fixed-rate debt (i.e. there cannot be any variability in DSC outcomes on these obligations).

With respect to SBD denominated floating-rate debt, a reliable market based reference rate does not currently exist. It is important to note therefore that, with respect to SBD denominated floating-rate debt, both the movement in the market based reference rate, and the methodology underpinning how the reference rate is set, are sources of interest rate risk for SIG on any SBD denominated floating-rate debt.

If unaffordable, adverse DSC outcomes, which have been caused by the materialisation of interest rate risk, are likely to cause a SIG default.

2.1.3. Repricing risk

Repricing risk refers to the potential for interest rates to have increased when maturing debt is due to be refinanced. This risk only applies if SIG opts to finance a longer-term funding requirement, by rolling over debt obligations that are shorter in term than the funding requirement.

To meet a long-term funding requirement, SIG has two options, being: 1) a fixed-rate obligation with a tenor that matches the expected term of the funding requirement; or 2) rollover a series of fixed-rate obligations, where the sum of the tenors of each obligation matches the expected term of the funding requirement. Option 2 comes with the risk that the average rate of interest over the term of the funding requirement is greater than the fixed interest rate available under option 1.

If unaffordable, adverse DSC outcomes, which have been caused by the materialisation of repricing risk, are likely to cause a SIG default.

2.1.4. Rollover/refinancing risk

Rollover/refinancing risk refers to the potential that SIG cannot issue enough new debt to repay the principal due at maturity of existing debt, resulting in a default.

This risk exposure exists if SIG adopts a strategy to rollover and refinance maturing debts, instead of repaying them from forecast revenues and/or accumulated cash reserves.

[2] Refer to section 5.1.4 of the Debt Management Strategy.

2.1.5. Market risk

Market risk refers to the potential for interest rates to decrease during the term of a debt obligation, which means the borrower has possibly forgone an opportunity to have a lower DSC.

Materialisation of market risk will result in adverse cost outcomes on SIG direct borrowing, but is unlikely to result in a default.

2.1.6. Duration mismatch risk

This refers to the risk of default on a SIG direct borrowing that is caused by a mismatch in the profile of revenues (which are expected to be generated by a project that is to be funded by a borrowing) and the DSR profile of payments associated with the borrowing. Materialisation of this risk can contribute to a default.

2.2. Economic risks for SIG

Economic risk, with respect to SIG direct borrowing, refers to the increased likelihood of default that can be ***attributed to unexpected economic outcomes*** (e.g. Government revenue lower than forecast).

The economic risk exposure that needs to be considered by SIG when considering a proposal to directly borrow is summarised below.

2.2.1. Revenue risk

Revenue risk refers to the potential that SIG does not have sufficient funds to meet scheduled DSR payments on a direct borrowing because revenues are less than what has been forecast, resulting in a default.

2.3. Non-financial risks for SIG

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 SIG when evaluating a direct borrowing are summarised below.

2.3.1. 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. With respect to SIG direct borrowing, the operational risk exposure lies with the DMU.

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 DSR payment.

2.3.2. 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. With respect to SIG direct borrowing, the legal risk exposure lies with the DMU.

2.3.3. 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. With respect to SIG direct borrowing, the reputational risk exposure lies with SIG.

2.3.4. Creditor concentration risk

Creditor concentration risk relates to the prospect that any one creditor can have undue influence over a borrower because they are the counterparty to a proportionately large amount of the borrower's total borrowing. With respect to SIG direct borrowing, the creditor concentration risk exposure lies with SIG.

2.3.5. Implementing agency financial management risk

Implementing agency financial management risk relates to the prospect that the proceeds of a SIG direct borrowing are mismanaged by the Implementing Agency. Were this risk to materialise, the Solomon Islands might not realise the net economic return that was expected from entering into the direct borrowing.

3. ELIGIBILITY FOR SIG DIRECT BORROWING

3.1. Entity eligibility

The Minister ***will only*** consider authorising a SIG direct borrowing if the Implementing Agency has no:

- trade creditor arrears; or
- National Provident Fund (NPF) contribution arrears.

The Implementing Agency is required, as a first step in the evaluation process (refer to section 2 of the SIG Direct Borrowing Evaluation Guidelines), to undertake a self-assessment test (refer to section 3.1 of the SIG Direct Borrowing Evaluation Guidelines) to determine entity eligibility.

3.2. Project eligibility

The Minister ***will only*** consider authorising a SIG direct borrowing 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
- 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.

The Implementing Agency is required, as a first step in the evaluation process (refer to section 3 of the SIG Direct Borrowing Evaluation Guidelines), to undertake a self-assessment test (refer to section 3.1 of the SIG Direct Borrowing Evaluation Guidelines) to determine project eligibility.

3.3. Ineligible uses of funds borrowed directly by SIG

The Minister ***will not*** authorise a SIG direct borrowing if the proceeds of the borrowing are to be used to finance:

- SIG recurrent expenditure; or
- a cross-subsidy of another Government Ministry.

4. PROPOSAL EVALUATION

4.1. Evaluating SIG direct borrowing proposals

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

An Implementing Agency must comply with the evaluation process outlined in the SIG Direct Borrowing Evaluation Guidelines if it wishes to seek ministerial authorisation for a SIG direct borrowing proposal.

4.1.1. SIG Direct Borrowing Evaluation Guidelines

This Policy should be read in conjunction with the SIG Direct Borrowing Evaluation Guidelines.

Those Guidelines outline the process to be followed by all stakeholders for the evaluation of SIG direct borrowing 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 SIG direct borrowing proposals in a timeframe that is inconsistent with the annual Development Budget process. These circumstances are outlined in the Guidelines.

4.1.2. 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.

5. GUIDANCE ON ACCEPTABLE SIG DIRECT BORROWING TERMS

5.1. Concessional financing

Key point: ***The Minister shall only authorise SIG direct borrowing from concessional sources****. Typically, concessional financing:*

- *is denominated in USD or Special Drawing Rights (SDR);*
- *is fixed-rate debt with an interest rate lower than prevailing market rates;*
- *includes long principal repayment grace periods; and*
- *is longer-term debt than what can be offered by commercial lenders.*

Concessional financing is typically provided by:

1. International Financial Institutions (IFIs) such as the World Bank (WB) or Asian Development Bank (ADB);
2. Bi-lateral development funds (e.g. country sponsored official development assistance);
3. Special purpose multilateral funds (e.g. Green Climate Fund).

Each of the IFIs provides different loan programs. For example, the WB provides International Development Association (IDA), Blended and International Bank for Reconstruction and Development (IBRD) loan packages. IDA loans are the most concessional and IBRD are the least concessional. The WB performs periodic Country Policy and Institutional Assessments (CPIA) to determine which loan package a country is eligible for. ***Currently, the Solomon Islands is eligible for IDA loans***, which have an interest rate of 0.75% (referred to as a service fee by the WB), a 40-year tenor and a 10-year principal repayment grace period. These borrowing terms could become less concessional if the Solomon Islands CPIA rating improves over time.

Similarly, the ADB has different loan packages and performs Country Performance Assessments (CPA) to determine which loan package a specific country is eligible for. ***Currently, the Solomon Islands is eligible for Asian Development Fund (ADF) loans***, which have interest rates (referred to as a service fee by the ADB) of 1.00% during the grace period and 1.50% during the amortizing period, a 32-year tenor and a 8-year principal grace period. These borrowing terms could become less concessional if the Solomon Islands CPA rating improves over time.

The concessionality of any proposed concessional financing, which is from non-IFI sources, should be benchmarked for appropriateness against the WB and ADB loan packages that the Solomon Islands is eligible for.

5.1.1. Measuring concessionality

The grant element of concessional financing should be calculated by the DMAC Secretariat.

It is important to note that, when calculating the grant element, concessional financing is often provided by lenders as a mix of loan and grant, which we will refer to as the ‘total funding envelope’. In such cases, the grant element should be calculated for both the loan and the total funding envelope.

Grant element of a loan

The grant element of a loan, using a discount rate of 10%, is calculated using the following formulae:

$$100\% - \frac{\text{Present value of the loan}}{\text{Face value of the loan}}$$

The ***minimum acceptable grant element*** for a loan is 25%.

Grant element of a total funding envelope

The grant element of the total funding envelope, using a discount rate of 10%, is calculated using the following formulae:

$$100\% - \frac{\text{Present value of the total funding envelope}}{\text{Face value of the total funding envelope}}$$

The ***minimum acceptable grant element*** for a total funding envelope is 25%.

5.2. Denominated currency

Key point: *Concessional debt financing is typically denominated in USD or SDR. Attaining concessional financing is the main objective for SIG with respect to direct borrowing. The Minister of Finance shall only consider SBD denominated direct borrowing if it is concessional and can be shown to be a cheaper form of debt, on a risk-adjusted cost basis, than foreign currency denominated concessional debt alternatives.*

5.3. Interest rate – Fixed or floating

Key point: *Concessional debt financing is typically fixed-rate debt. SIG should make every effort to enter into fixed-rate direct borrowing rather than floating/variable rate. SIG direct borrowing may be concessional floating-rate debt, in exceptional circumstances, where it can be demonstrated that it is a cheaper form of debt, on a risk-adjusted cost basis, than concessional fixed-rate debt alternatives.*

5.4. Tenor

Key point: *Concessional debt financing is typically offered with long tenors (i.e. generally 20 years or longer), which are non-negotiable. Concessional financing with a tenor of greater than, or equal to, 20 years or longer is acceptable.*

5.5. Grace period

Key point: *Concessional debt financing is typically offered with long grace periods (i.e. generally 5 years or longer), which are non-negotiable. Concessional debt financing with a grace period of greater than, or equal to, 5 years or longer is acceptable.*

6. RECOGNITION, REPORTING AND DISBURSEMENT OF SIG DIRECT BORROWING

6.1. Recognition and reporting as Government borrowing

All SIG direct borrowing 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.

6.2. Counting against the Annual Borrowing Limit (ABL)

All SIG direct borrowing 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.

6.3. Disbursement of SIG direct borrowings

Disbursement procedures need to be agreed with the lender before a financing agreement is signed to formalise a SIG direct borrowing. 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 and the lender.

Furthermore, the PFMA requires borrowed funds 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 Central Bank of Solomon Islands (CBSI) in the name of SIG will satisfy the requirement for borrowed funds to be paid into the Consolidated Fund.

6.4. Monitoring

The DMU should develop and follow a process to track and monitor disbursements of SIG direct borrowings.

This monitoring process is important to ensure that SIG can accurately report on the stock of SIG direct borrowing.

7. BUDGETING FOR SIG DIRECT BORROWING

SIG direct borrowing, and the expenditure of the proceeds from the borrowing, consists of many distinct monetary flows that need to be budgeted for in SIG's annual Budget. Please refer to Appendix 1 of this Policy for guidance on how to appropriate for each specific flow. These flows are:

1. Loan disbursements / proceeds;
2. Grant disbursements / proceeds that are tied to the loan (only applies when grant funding is tied to the debt funding);
3. Disbursement of loan proceeds to implementing agency;
4. Expenditure of loan proceeds by implementing agency;
5. Disbursement of grant proceeds to implementing agency (only applies when grant funding is tied to the debt funding);
6. Expenditure of grant proceeds by implementing agency (only applies when grant funding is tied to the debt funding); and
7. DSR payments.