

# SUB-NATIONAL DIRECT BORROWING POLICY

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Solomon Islands Government

Approved by Minister of Finance

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# SUB-NATIONAL DIRECT BORROWING POLICY

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## ABBREVIATIONS

ABL	Annual Borrowing Limit
CBSI	Central Bank of Solomon Islands
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
MoFT	Ministry of Finance and Treasury
NDS	National Development Strategy
NIIP	National Infrastructure Investment Plan
NPF	National Provident Fund
PFMA	Public Financial Management Act
SOE	State Owned Enterprise
SCO	Statement of Corporate Objectives
SIG	Solomon Islands Government

## EXECUTIVE SUMMARY

A sub-national entity is a legal entity that has been created through an act of parliament to perform certain functions that have been stipulated in the respective creating legislation. Sub-national entities in the Solomon Islands are State Owned Enterprises (SOEs) and provincial Governments.

SOEs have been given their legal status, and are governed, through the State Owned Enterprises Act 2007 (SOE Act) and, in most instances, enabling legislation. The Solomon Islands Government (SIG) has an ownership stake in all SOEs, either in full or in part. Provincial Governments have been given their legal status, and are governed, through the Provincial Government Act 1997 (PG Act). Honiara City has been given legal status, and is governed, through the Honiara City Act 1999 (HC Act).

The Central Bank of Solomon Islands (CBSI) is another legal entity that has been created through an act of parliament. CBSI is not however considered to be a sub-national entity, for the purpose of debt management, because central bank independence is considered to be a crucial element for promoting effective monetary policy.

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 sub-national entity direct borrowing 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.

Sub-national entities have been established by central government to perform services (on a commercial basis) for Solomon Islanders and manage provincial affairs. Given the community service nature of many of these services and affairs, there is an underlying community expectation that central government would financially support a sub-national entity should their financial position prevent them from delivering the services expected by the community.

It is for this reason that sub-national entity direct borrowings are recognised as contingent liabilities on SIG's balance sheet and are actively managed as part of the DMF. Direct sub-national entity direct borrowings that **are not** formally guaranteed by central government are recognised as implicit contingent liabilities by SIG and are governed by this Sub-national Direct Borrowing Policy. For clarity, sub-national entity direct borrowings that **are** formally guaranteed by SIG are recognised as explicit contingent liabilities and are dealt with under the DMF by the Government's Guarantee Policy.

This Policy upholds the fundamental principles of sound Government decision making (accountability and transparency) and promotes the prudent use of public resources. This Policy governs all sub-national entity direct borrowing that is not guaranteed by SIG. 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.

# **1. INTRODUCTION**

## **1.1. Definition of sub-national entity**

A sub-national entity is a legal entity that has been created through an act of parliament to perform certain functions that have been stipulated in the respective creating legislation. Examples of sub-national entities in the Solomon Islands are provincial Governments and State Owned Enterprises (SOEs). For the purpose of debt management in the Solomon Islands, CBSI is not considered to be a sub-national entity.

## **1.2. Sub-national entities in the Solomon Islands**

Solomon Islands currently has nine provincial Governments, which are considered to be sub-national entities for the purpose of debt management in the Solomon Islands. These provincial Governments are:

- Central Province;
- Choiseul Province;
- Guadalcanal Province;
- Isabel Province;
- Makira Ulawa Province;
- Malaita Province;
- Rennel and Bellona Province;
- Temotu Province; and
- Western Province.

In addition, for the purpose of debt management in the Solomon Islands, Honiara City is also considered to be a sub-national entity.

Solomon Islands currently has eight SOEs, which are considered to be sub-national entities for the purpose of debt management in the Solomon Islands. These SOEs are:

- Commodities Export and Marketing Authority (CEMA);
- Investment Corporation of Solomon Islands (ICSI);
- Solomon Airlines Ltd;
- Solomon Islands Broadcasting Corporation (SIBC);
- Solomon Islands Electricity Authority (SIEA);
- Solomon Islands Ports Authority (SIPA);
- Solomon Islands Postal Corporation (SIPC); and
- Solomon Islands Water Authority (SIWA).

## **1.3. PFMA legal provisions relating to sub-national direct borrowing**

Refer to section 3.2.1.1 of the DMS for a summary of legal provisions included in the PFMA that relate to sub-national entity direct borrowing. Two key statutory provisions are outlined below.

### **1.3.1. Ministerial consent**

The PFMA requires all sub-national entities to acquire consent from the Minister of Finance to undertake direct borrowing (refer to section 3.2.1.1.4 of the DMS).

### **1.3.2. Debt Management Advisory Committee (DMAC) evaluation**

Before making a decision on whether to consent to a sub-national entity direct borrowing, the Minister of Finance is required under the PFMA to seek out the advice of the DMAC on whether to provide consent. The DMAC will therefore evaluate every sub-national entity direct borrowing proposal in order to provide a properly informed recommendation to the Minister of Finance.

## **1.4. Exempt sub-national entity direct borrowing/obligations**

Consistent with section 8.3 of the DMS, some types of sub-national direct borrowing/obligations are exempt from the DMAC evaluation and ministerial approval/consent process. Exempt obligations are:

1. short-term working capital facilities (e.g. commercial bank overdraft) that are the lesser of:
  - a. 25% of the entity's net current assets (i.e. Total current assets – Total current liabilities); and
  - b. SBD 1 million.
2. secured asset financing facilities (e.g. equipment lease finance and equipment hire-purchase) that are fully secured by the assets which have been purchased with the finance (i.e. this exemption does not apply where assets, not related to the financing, are provided as security).
3. financial instruments (e.g. diesel futures contracts) that provide for the physical delivery of a good or service to the sub-national entity.

## **1.5. Legislation governing sub-national entities in the Solomon Islands**

All provinces in the Solomon Islands are governed by the *Provincial Government Act (PG Act) 1997*.

Honiara City is governed by the *Honiara City Act (HC Act) 1999*.

Each SOE in the Solomon Islands is governed by the respective acts listed below:

- CEMA - *State Owned Enterprises Act (SOE Act) 2007* and *Commodity Export Marketing Authority Act 1985*
- ICSI - *SOE Act* and *Investment Corporation of Solomon Islands Act 1988*
- Solomon Airlines Ltd - *SOE Act* and *Companies Act 1996*
- SIBC - *SOE Act* and *Broadcasting Act 1977*
- SIEA - *SOE Act* and *Electricity Act 1969*
- SIPA - *SOE Act* and *Ports Act 1956*
- SIPC - *SOE Act* and *Post Office Act 1971*
- SIWA - *SOE Act* and *Solomon Islands Water Authority Act 1993*

Under the SOE Act, the Minister of Finance, together with the Responsible Minister, are 'Accountable Ministers'. The role of Accountable Ministers is to oversee the operations of an SOE and manage any potential risks to SIG.

Under section 13 of the SOE Act, the board of every SOE is required to provide its Accountable Ministers with a statement of Corporate Objectives, which amongst others things, are required to set out borrowing intentions.

Enabling legislation relating to individual SOEs contain general financial provisions relating to SOE borrowing. In general, these acts allow for SOEs to borrow in certain circumstances following approval by the Minister of Finance or the Responsible Minister, after consultation with the Minister of Finance.

Although Solomon Airlines Ltd comes under the Companies Act 1996 rather than enabling legislation, the provisions of the SOE Act take precedence (refer to section 25 of the SOE Act).

### **1.6. Sub-national entity direct borrowing and central government**

Although central government is not legally obligated to repay non-guaranteed sub-national entity direct borrowing that is in default, there is a strong community expectation that SIG would repay sub-national debts that are in default, because of the: 1) public utility nature of the services provided by sub-national entities; and 2) the link between central government and sub-national entities.

It is for this reason that proposed sub-national entity direct borrowing is scrutinized under the DMF and is actively managed by SIG. It is also for this reason that applicable sub-national entity direct borrowing is recognised as '**Government borrowing**' by SIG under the DMF.

Scrutinizing all sub-national entity direct borrowing under the DMF aims to mitigate the risk that sub-national borrowing becomes a central government debt burden that leads to an unsustainable level of debt for SIG.

### **1.7. Scope of this Policy**

The scope of this Policy is to provide evaluation and decision making guidance for sub-national entities, 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 sub-national entity direct borrowing.

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 sub-national entity direct borrowing are not repeated in this Policy.

### **1.8. Objectives of this Policy**

Primary objectives of this Policy are to:

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



2. provide clarity to sub-national entities that are contemplating direct borrowing on how to meet their legal obligations under the PFMA;
3. provide operational clarity to the DMAC Secretariat on how to evaluate sub-national entity direct borrowing proposals; and
4. provide clarity to sub-national entities, lenders and the DMAC on the evaluation process for proposed sub-national entity direct borrowing (N.B. this policy is to be read in conjunction with the ***Sub-national 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.

### **1.9. Administration of this Policy**

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

### **1.10. 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 sub-national entities with respect to servicing their direct borrowing obligations.

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

## 2. GENERAL PRINCIPLES OF THIS POLICY

The PFMA requires all sub-national entity direct borrowings to be recognised as Government borrowing. This legislative requirement ***should in no way be misinterpreted by lenders as being a signal from Government that any sub-national entity direct borrowing, which is in default, will be repaid by SIG.***

For sake of clarity, this Policy refers to the ‘expectation’ that SIG would repay sub-national entity direct borrowing in default, which in no way constitutes the provision of a guarantee by SIG. Were lenders to misinterpret the policy intent of the PFMA, with respect to sub-national direct borrowing being recognised as Government borrowing, moral hazards could emerge, competitive neutrality issues could arise and/or private sector investment could get crowded out.

A moral hazard could emerge if a lender is inclined to take on more risk, than they otherwise would, because they believe the costs associated with the risks materialising will be borne by another party. With respect to sub-national entity direct borrowing, this taking on of additional risk by the lender might manifest itself in the form of, for example, poor due diligence, poor loan agreement monitoring or lending to entities that would otherwise be deemed to be not credit worthy.

Competitive neutrality issues could arise if the commercial interests of one entity are advantaged over the interests of another entity because of Government support (or a perception of support) provided to the former entity. Again, these issues could arise if lenders believe that their loans to sub-national entities are automatically guaranteed by SIG. Were this the case, lenders might form a view that lending to sub-national entities is lower risk compared to lending to private sector firms operating in comparable sectors. In such a case, lenders might then offer more favourable lending terms to sub-national entities, compared to what might be offered to private sector firms operating in comparable sectors.

Unnecessary crowding out of private sector investment may also occur if lenders misconstrue the Government’s policy. If lenders have a limited volume of funds available for lending, then they might be inclined to lend to perceived better credit (i.e. that which they believe to be supported by Government). Private sector investment may therefore get crowded out.

As general principles, this Policy aims to: 1) avoid the creation of any moral hazards; 2) target a level playing field for entities seeking to tap the domestic financial system for financing; and 3) prevent crowding out of financing to the private sector.

### 3. RISKS ASSOCIATED WITH SUB-NATIONAL ENTITY DIRECT BORROWING

The risk exposures associated with sub-national entity direct borrowing are summarised below.

Materialisation of one, or a combination, of these risks can result in adverse cost outcomes for both the sub-national entity and/or SIG.

Materialisation of these risks can also cause a **default** on a sub-national entity direct borrowing, or on a portfolio of direct borrowings.

Default is undesirable for a sub-national entity because it can:

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

Default by a sub-national entity on a direct borrowing is also undesirable from SIG's perspective because of the direct financial loss that SIG might incur as a result.

#### 3.1. Financial risks for sub-national entities

Financial risk, with respect to sub-national entity direct borrowing, 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).

Unmanageable and adverse variances in cost outcomes have the potential to make a debt obligation, or portfolio of obligations, unsustainable and/or unaffordable for a debtor, which can in turn increase the likelihood of default.

If a sub-national entity knows the quantum of its future debt servicing requirements on an obligation, **with certainty**, then that obligation exhibits no risk. Conversely, if the debtor does not know, with certainty, the quantum of future cost outcomes, then those cost outcomes are subject to risk.

The types of financial risk exposures that need to be considered by sub-national entities when considering a proposal to directly borrow, are summarised below. These financial risk exposures also need to be considered by SIG when evaluating a sub-national entity direct borrowing proposal.

##### 3.1.1. Revenue risk

Revenue risk refers to the potential that a sub-national entity borrower does not have sufficient funds to meet scheduled debt servicing requirement payments on a direct borrowing because revenues are less than what has been forecast, resulting in a default: this is therefore also a risk exposure for SIG.

##### 3.1.2. Rollover/refinancing risk

Rollover/refinancing risk refers to the potential that a sub-national entity borrower cannot issue enough new debt to repay the principal due at maturity of existing debt, resulting in a default: this is therefore also a risk exposure for SIG.

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

### **3.1.3. Duration mismatch risk**

This refers to the risk of default on a sub-national entity 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 the borrowing) and the profile of debt servicing requirement payments associated with the borrowing. Materialisation of this risk can contribute to a default: this is therefore also a risk exposure for SIG.

### **3.1.4. Foreign exchange risk**

Foreign exchange risk refers to the potential for variability in the SBD value of future debt service requirement payments, due on foreign currency denominated sub-national direct borrowings, which are unhedged. The SBD value of these payments are a function of: 1) the foreign currency denominated value of debt service payments; and 2) foreign exchange rates prevailing at the time the debt service requirements are scheduled to be paid.

Materialisation of foreign exchange risk can result in adverse cost outcomes on sub-national direct borrowings, which in turn can be the cause of a default on these borrowings: this is therefore also a risk exposure for SIG.

### **3.1.5. Interest rate risk**

Interest rate risk refers to the potential for variability in the SBD value of future interest payments, due on variable/floating-rate sub-national direct borrowings, which are unhedged. The SBD value of interest payments on variable/floating rate direct sub-national borrowings are a function of the variable interest rate prevailing at the time the interest payment is scheduled to be paid. There is no interest rate risk exposure on fixed-rate debt (i.e. there cannot be any variability in interest cost 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 sub-national entity on any SBD denominated floating-rate debt.

Materialisation of interest rate risk can result in adverse cost outcomes on sub-national direct borrowings, which in turn can be the cause of a default on these borrowings: this is therefore also a risk exposure for SIG.

### **3.1.6. Repricing risk**

Repricing risk refers to the potential for interest rates to have increased when maturing debt is due to be refinanced. Sub-national entities that opt to finance a longer-term funding requirement, by rolling over shorter-term debt obligations, are exposed to repricing risk.

To meet a long-term funding requirement, a sub-national entity 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.

Materialisation of repricing risk can result in adverse cost outcomes on sub-national direct borrowings, which in turn can be the cause of a default on these borrowings: this is therefore also a risk exposure for SIG.

### **3.2. Non-financial risks for sub-national entities**

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 sub-national for direct borrowing are summarised below.

Combined, these non-financial risks can be contributing factors to a default.

#### **3.2.1. 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.

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.

#### **3.2.2. 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.

#### **3.2.3. 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.

#### **3.2.4. Creditor concentration risk**

Creditor concentration risk relates to the prospect that any one creditor can have undue influence over a sub-national entity because they are the counterparty to a proportionately large amount of the entity's total borrowing.

### **3.3. Risks to be considered by SIG**

Materialisation of any of the above risks (i.e. financial and/or non-financial) can contribute to a default by a sub-national entity on their direct borrowings.

All of the above risks therefore need to be considered by the DMAC and the Minister of Finance when a proposal for sub-national direct borrowing is being evaluated for the granting of consent by the Minister of Finance.

## 4. ELIGIBILITY FOR SUB-NATIONAL ENTITIES TO DIRECTLY BORROW

### 4.1. Entity eligibility

The Minister **will only** consider providing consent for direct borrowing for the following sub-national entities:

- 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; and
  - have no tax arrears.

A sub-national entity intending to undertake direct borrowing is required, as a first step in the evaluation process (refer to section 2 of the Sub-national Direct Borrowing Evaluation Guidelines), to undertake a self-assessment test (refer to section 3.1 of the Sub-national Direct Borrowing Evaluation Guidelines) to determine entity eligibility.

### 4.2. Project eligibility

The Minister **will only** consider providing consent for a sub-national entity’s direct borrowing proposal if the project that will be funded by the borrowing:

- Complies with sections 8.13 and 8.14 of the DMS; and
- has previously been included by an SOE in a SCO provided to the MoFT (N.B. This only applies to direct borrowing proposed by a SOE); and
- **exhibits** commercial like characteristics (refer to section 4.2.1 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.

A sub-national entity intending to undertake borrowing is required, as a first step in the evaluation process (refer to section 2.1 of the Sub-national Direct Borrowing Evaluation Guidelines), to undertake a self-assessment test (refer to section 3.1 of the Sub-national Direct Borrowing Evaluation Guidelines) to determine project eligibility.

#### 4.2.1. Commercial like characteristics

SOEs under the SOE Act are required to act commercially when conducting their business. 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.

#### **4.3. Ineligible uses of funds borrowed directly by sub-national entities**

The Minister **will not** consider providing consent for a sub-national entity's direct borrowing proposal if the proceeds of the borrowing are to be used to finance:

- The sub-national's recurrent expenditure; or
- a cross-subsidy of another sub-national entity; or
- the continuation of poor management.



## **5. PROPOSAL EVALUATION**

### **5.1. Evaluating proposed sub-national entity direct borrowing proposals**

The process for proposal evaluation, which is the precursor to a DMAC recommendation to the Minister on whether to provide consent to a sub-national entity to directly borrow, is outlined in the Sub-national Direct Borrowing Evaluation Guidelines (refer to ‘Evaluation process – four pool approach’ in section 2 of the Guidelines).

A sub-national entity proposing to undertake direct borrowing must comply with the evaluation process outlined in the Sub-national Direct Borrowing Evaluation Guidelines.

#### **5.1.1. Sub-national Direct Borrowing Evaluation Guidelines**

This Policy should be read by stakeholders (e.g. sub-national entities that wish to directly borrow from commercial lenders) in conjunction with the Sub-national Direct Borrowing Evaluation Guidelines.

Those Guidelines outline the process to be followed by all stakeholders for the evaluation of sub-national entity 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 proposed sub-national entity direct borrowing 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 BORROWING TERMS

### 6.1. Denominated currency

**Key point:** Sub-national entities should make every effort to denominate their proposed direct borrowing in SBD rather than in a foreign currency. Sub-national direct borrowing may be foreign currency denominated, in exceptional circumstances, where the sub-national entity can demonstrate that:

- every effort was made to denominate the borrowing in SBD, but: and/or
  - no lenders were willing to provide SBD funding to fund the proposed project; and/or
  - the risk-adjusted cost of SBD denominated debt was unacceptably high compared to foreign currency denominated borrowing.
- it has the capacity to manage foreign exchange rate risk.

### 6.2. Interest rate – Fixed or floating

**Key point:** Sub-national entities should make every effort to enter into fixed-rate borrowing rather than floating/variable rate. Sub-national entity direct borrowing may be floating-rate debt, in exceptional circumstances, where the sub-national entity can demonstrate that:

- every effort was made to fix the interest rate, but: and/or
  - no lenders were willing to provide fixed-rate funding to fund the proposed project; and/or
  - the risk-adjusted cost of fixed-rate debt was unacceptably high compared to floating-rate debt.
- it has the capacity to manage floating rate debt.

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 sub-national entity) repayment risk exposure as they are susceptible to large increases in the interest rate.

### 6.3. Tenor

**Key point:** The repayment period for a sub-national entity direct borrowing should take into consideration the forecast cash flows and economic life of the project that the borrowing is to fund.

Principal repayments should be made over a period in line with the expected economic life of the project.

### 6.4. Grace period

**Key point:** Principal repayments on sub-national entity direct borrowing should ideally begin no sooner than the year in which the project is expected to be operational and realizing sufficient cash flow to make repayments.

## **7. RECOGNITION, REPORTING AND MONITORING OF SUB-NATIONAL DIRECT BORROWING**

### **7.1. Recognition and reporting as Government borrowing**

All applicable sub-national entity direct borrowing (refer to section 1.4 of this Policy) 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.

### **7.2. Counting against the Annual Borrowing Limit (ABL)**

Section 8.7 of the DMS provides for certain implicit contingent liabilities to be risk-adjusted when determining how much Government borrowing should be counted against a respective ABL.

All sub-national entity direct borrowing that is regarded as Government borrowing, shall therefore be recognised either on a 100% of face/notional value basis, or risk-adjusted basis of 50%, against the ABL year in which the borrowing has been recognised as a Government borrowing in accordance with section 8.5 of the DMS.

#### **7.2.1. Application of 50% risk-adjustment**

It is at the Minister's discretion to apply the 50% risk-adjustment referred to above in section 7.2 of this Policy after having received a recommendation from the DMAC. Application of this risk-adjustment is subject to the credit worthiness of the sub-national entity that intends to directly borrow.

### **7.3. Monitoring**

SIG should monitor the performance of sub-national entities that have taken on direct borrowing that is regarded as Government borrowing. SIG should utilise existing information flows (e.g. Annual Statement of Corporate Objectives (SCO) and annual financial reporting) to monitor these entities.

This monitoring function is important to ensure both that:

- Sub-national entities have not entered into direct borrowing without meeting the requirements of the DMF; and;
- SIG is aware of any issues that might result in a default by a sub-national entity that has entered into a direct borrowing.