Annex 1

Government Guarantee Policy for Tonga

This document sets out the policy of the government with regard to guaranteeing the debts of other entities.

By reducing the risk that the lender will not be repaid, a government guarantee can promote investment. At the same time, it creates a risk for the government that is similar to the risk that the government assumes when it borrows to finance productive investment. The government therefore scrutinizes requests for guarantees in the light of both the prospective costs and benefits of the guarantee and the soundness of the government's finances, including the projected debt sustainability.

The Public Finance Management Act 2002 governs the granting of guarantees. The Act provides that only the Minister of Finance may give a guarantee and that the Minister of Finance may give a guarantee only with the approval of the Cabinet. The granting of guarantees is also subject to the limit imposed by the Act, unless there are special circumstances that make it expedient to exceed the limit, in which case the Minister of Finance may seek the Cabinet's approval to do so.

This policy sets out more detailed provisions regarding guarantees in the following areas:

- The criteria that proposed guarantees must meet to be given.
- Additional guidelines the government will use to evaluate a request for a guarantee.
- The information that must be submitted to the Ministry of Finance with any request for a guarantee.
- The fees the government expects to charge for a guarantee.
- Other obligations that the government may impose on borrowers seeking a guarantee.
- The public disclosure government guarantees.

Criteria

The government will give a guarantee only if all the following four criteria are met:

1. The guarantee is permitted by the Public Finance Management Act, the budget law, and other legislation;
2. Except in emergencies, the borrower's current and projected finances are such that the borrower can reasonably be expected to repay the borrowing;
3. The remaining fiscal risk created by the guarantee is deemed to be manageable given the state of government finances, including the projected sustainability of public debt; and

4. The guarantee is deemed to offer a prospective net benefit to Tonga that is greater than the net benefit of alternative options, including the option of giving no guarantee or other assistance and the option of giving assistance in a form other than a guarantee.

Additional guidelines

In addition, the government expects to look more favourably on requests for guarantees to the extent that they also satisfy the following conditions:

1. The borrowing is by an entity, such as a public enterprise, that is owned by the government.

2. The borrowing is denominated in pa'anga and is not indexed to any foreign currency.

3. The borrowing is concessional, for example because it contains a grant element, and a guarantee is required by the lender.

4. The project the borrowing will finance has passed a credible economic cost-benefit test.

5. The guarantee is partial in the sense that it covers less than 100 per cent of the debt-service payments or only some of the risks that may lead to default.

Information to be submitted with proposals

Each of the four criteria and five guidelines above will be discussed in the cabinet submission on a possible government guarantee. The government therefore expects to consider a request for a guarantee only after the requester has provided the following information:

- Details of the borrowing that would be guaranteed, including the lender and the borrowing's amount, currency, term, and interest rate (including whether it is fixed or floating).

- Details of the use that will be made of the borrowed money, including a description of the project and any associated business case, feasibility study, or cost-benefit analysis.

- The borrower's audited financial statements for the past three years.

- Prospective *pro forma* financial statements for the borrower for each year of the term of the proposed guarantee. The statements should include a statement of financial performance (profit and loss), a statement of financial position (balance sheet), and a statement of cash flows. They should be prepared on the same basis as the audited financial statements.

- A statement of the borrower's and lender's strategies for minimizing the risk of a call on the guarantee.

- A justification of the guarantee that refers to the above criteria and guidelines.

Fees

The government expects borrowers who receive a government guarantee to pay a fee of 3 per cent of the value of the borrowing on the signing of the guarantee contract and a fee of 1 per cent of the outstanding value of the borrowing at the beginning of each subsequent year after the first.

Other conditions

The government also expects to include in any guarantee contract any conditions necessary and appropriate to (i) reduce the risk of the guarantee being called; (ii) allow the government to recover any amounts it pays under the guarantee; and (iii) ensure that the borrower and/or lender submit financial information that allows the government to monitor, in a timely way, the risk of the guarantee being called.

Disclosure

The government will disclose any guarantees it gives as follows:

- When the government issues a guarantee, the Ministry of Finance will publish on its website the amount of the guarantee, the name of the borrower, the name of the lender, the main terms of the borrowing (term, currency, interest rate), and a brief statement of the purpose of the guarantee.

- The budget statement and the annual financial statements of the government will each disclose, for each outstanding guarantee, the amount of guaranteed debt that is outstanding, the name of the borrower, the name of the lender, the main terms of the borrowing (term, currency, interest rate), and a brief statement of the purpose of the guarantee.

- In the budget statement, the government will also disclose the total amount of the government's direct debt (i.e., borrowing by the government itself), the total amount of guaranteed debt, and the sum of these two amounts (direct and guaranteed debt).