GOVERNMENT ON-LENDING POLICY FOR TONGA

1. GENERAL PROVISIONS

1.1 PURPOSE

This policy outlines The Government of Tonga's approach to on-lending to private companies and state-owned enterprises (SOEs) under a loan agreement, supporting development goals while managing associated fiscal risks. Government on-lending policy aims to promote investment while ensuring risks arising from these on-lending operations do not undermine fiscal stability or debt sustainability.

1.2 DEFINITIONS

In this policy, unless the context otherwise requires

"Borrower" means the entity who is requesting on-lending loan from the Government.

"CEO" unless otherwise specified means Chief Executive Officer for Finance.

"Debt Sustainability" means the ability of the Government to service its debt obligations without compromising its fiscal stability.

"FFD" means the Financial Framework Division under the Ministry of Finance.

"Government" means the Government of Tonga represents by the Ministry of Finance.

"Minister" unless otherwise specified means the Minister of Finance.

"On-lending" means borrowing by the Government with the aim of lending the funds to private and public institutions

"On-lending beneficiary" means the party who is the ultimate recipient of funds that are initially borrowed by the government.

"Default" means means the Borrower fails to make the required interest or principal repayments to the Lender (Government) as per signed loan agreement.

"Government" means the Government of Tonga.

"PDMC" refers to the Public Debt Management Committee.

"PFM Act" refers to the *Public Finance Management Act 2002* including any prospective future legal arrangements.

"Primary Loan Agreement" means the loan agreement mutually agreed to and signed by the Government and the Primary Lender (International Financial Institutions) under this Policy.

1.3 OBJECTIVES

1.3.1 The main objective of this Government On-lending Policy is to establish a clear framework toward the application of on-lent loans to support Tonga's development priorities while ensuring that the risks associated with these on-lending are managed prudently and minimized.

1.3.2 Specifically, the objectives of this framework are to:

a) **Operationalize the legal provisions** set forth in Part 5 – Borrowing, Loans and Guarantees Section 27 of the **Public Finance Management (PFM) Act 2002** and relevant regulations governing Government lending.

b) **Provide operational clarity** to all relevant stakeholders involved in the process of requesting, granting, and overseeing government lending.

c) **Ensure the prudent evaluation, monitoring, and management of the costs and risks** associated with the provision of government lending.

d) **Uphold the principles of transparency and accountability** in government decision-making related to the provision of on-lent loans, in accordance with applicable legal and regulatory standards.

e) **Promote the efficient and effective use** and management of public resources, ensuring that the provision of on-lent loans contributes to development objectives without jeopardizing fiscal stability.

1.4 SCOPE

1.4.1 This Policy applies to all requests for Government on-lending and oversight of these loans once approved.

1.4.2 The scope of this framework provides guidance and support the Government through a procedures and guidelines for on-lending beneficiaries and the Ministry.

1.4.3 This framework ensures compliance with relevant legal provisions and provides a structured approach to the management of government on-lending.

1.5 ADMINISTRATION AND REVIEW

1.5.1 The Government On-lending Policy shall be reviewed at least once every five (5) years hereon after or when there are significant changes in the applicable regulatory and standard requirements.

1.5.2 The review shall be conducted based on a range of information including the historical performance and compliance of on-lending entities.

1.5.3 The Financial Framework Division (FFD) at the Ministry of Finance shall be responsible for the administering of the government lending and shall submit to PDMC any reviews as per (1.5.1) above for endorsement.

2. LEGAL AND INSTITUTIONAL FRAMEWORK

2.1 LEGAL FRAMEWORK

2.1.1 The legislative framework for the granting and management of government on-lending is based on the following key legal instruments:

a) Public Finance Management Act (PFM Act 2002), including any prospective future legal arrangements.

b) Budget Appropriation Act.

2.2 CRITERIA

2.2.1 The Government shall consider applications for on-lending only if all the following criteria are met:

a) On-lending is permitted by the PFM Act, the Budget Appropriation Act, and other relevant legislation.

b) The on-lending beneficiary must have audited accounts, have existed for at least five (5) years, and demonstrate operational and financial capacity to service the loan. This is except for on-lending requests during a government-declared state of emergency.

c) The on-lending request must be consistent with any debt limits the government is subject to and with the principles of prudent fiscal management and sustainable debt management.

d) Issuance of subsequent loans to any entity shall be based on the satisfactory performance of previous loans and the outcome of the credit risk assessment.

e) The proposed on-lending beneficiary must score an acceptable rating of low risk, where this is not the case, the government will reserve the right to determine whether to approve or disapprove, based on the project's ability to generate positive financial and economic benefits to the country.

f) The on-lending must provide a net benefit to Tonga greater than alternative options, including the possibility of not lending and providing alternative forms of assistance. The government on-lending request shall be considered only under the following conditions:

   I. The policy objectives cannot be achieved without the on-lending operation.

   II. The on-lending improves the viability of public sector investment projects that offer significant social and economic benefits.

   III. The on-lending enables the borrower to access lower-cost financing that would otherwise be unavailable.

2.3 GOVERNANCE AND INSTITUTIONAL FRAMEWORK

2.3.1 The governance and institutional framework for managing government on-lending involves multiple entities with distinct roles and responsibilities (detailed in Annex 1) to ensure effective oversight, decision-making, and risk management. The parties involve with this framework are:

a) Ministry of Finance – Minister, CEO and Financial Framework Division

b) Public Debt Management Committee

c) Cabinet

d) Ministry of Public Enterprises

e) Attorney General

f) On-lending Beneficiary (Borrower)

2.4 SUBSIDIARY LOAN AGREEMENT (SLA)

2.4.1 The Ministry of Finance, in collaboration with the Office of the Attorney General, is responsible for preparing the On-lending Agreement. All documents must adhere to standardized templates to ensure consistency and legal compliance.

2.4.2 The Government and the Borrower will mutually agree and shall ensure that the SLA had adequate security against the loan.

2.4.3 The SLA shall also include the financial terms (interest rate, grace period, final maturity and fees) and shall align to the primary loan agreement term and conditions.

3. RISK MITIGATION MEASURES

3.1 LIMITS

3.1.1 The Government may lend up to 20 per cent of the total stock of public debt. However, if the Minister of Finance determines that there are special circumstances that will exceed the limit, the Minister shall seek the approval of the Cabinet, which may grant specific authorization for the excess.

3.1.2 The granting of on-lending is also subject to the limit of the Primary loan agreement.

3.2 CONDITIONS

3.2.1 On-lending beneficiaries shall use the loan proceeds solely for the purpose stated in the application for on-lending.

3.2.2 On-lending beneficiaries must provide the Ministry with periodic reports and audited financial statements or as specified in the loan agreement. Additionally, the On-lending beneficiaries shall provide ad hoc financial reports upon request from the Ministry as needed to monitor the utilization of funds as well as assessing the risk of default.

3.2.3 The request for on-lending shall not be considered if the applicant has outstanding tax liabilities or any arrears on government debt. The applicant must be free of all tax and debt arrears at the time of the request and must provide written confirmation from relevant authorities to this effect. Any arrears or outstanding liabilities must be settled before a request will be considered.

3.2.4 The government can include any additional support necessary and appropriate to (i) reduce the risks (ii) allow the government to recover any unpaid amounts under the on-lending and (iii) mitigate the impact of any unforeseen financial distress.

3.4 FEES

3.4.1 The government shall not charge the borrowers any additional on-lending fee apart from section 2.4.3.

3.4.2 In the event of a default, the government shall charge the borrowers a penalty fee of 0.25 percent annually, of the remaining outstanding amount.

3.5 COLLATERAL

3.5.1 The Government may require collateral to manage its risks, which may include physical or financial assets, or third-party guarantees. Collateral may be released upon completion of loan repayment or fulfilment of other conditions.

4. PROCEDURES AND GUIDELINES

4.1 APPLICATION PROCEDURES

4.1.1 All on-lending requests must be submitted to the CEO of the Ministry of Finance by the on-lending beneficiary. For SOEs, requests shall be conveyed to the Ministry through the Ministry of Public Enterprise.

4.1.2 On-lending requests may be submitted throughout the year and shall comply with applicable deadlines established by the Ministry.

4.1.3 The FFD shall conduct necessary assessment of the request before presenting to the CEO for consideration and conveyance to the Minister for final approval.

4.2 DOCUMENTATION REQUIREMENTS

4.2.1 The government shall only consider a request for on-lending upon receiving the following documentations:

a) Details of the loan, including the lender and the borrowing’s amount, currency, term, interest rate (including whether it is fixed or floating), and repayment profile.

b) Details of the utilisation of the borrowed money, including a description of the project and any associated business case, feasibility study, or cost-benefit analysis.

c) The borrower’s audited financial statements for the past five (5) years and a demonstrated operational and financial capacity to service the loan. If the borrower is a newly established entity, then it shall provide all years since establishment.

d) Prospective *pro forma* financial statements for the borrower for each year of the term of the proposed loan. 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.

e) A statement of the borrower’s strategies for minimizing the risk of a default.

f) A justification of the loan that refers to the above criteria and guidelines.

4.3 EVALUATION AND ASSESSMENT

4.3.1 The Ministry shall evaluate on-lending proposals based on the following key considerations:

a) Serve the public interest and maximizes social and economic benefits.
b) Contribute positively to the development priorities of the government.
c) Improves the financial viability of the project.
d) Have positive economic returns.

4.3.2 If the on-lending is determined to be necessary and cost-effective, the Ministry shall assess the associated risks and costs and recommend it to the Minister of Finance.

4.3.3 The process is as follows:

a) The CEO forwards the application to the Deputy CEO of FFD for assessment.

b) The Deputy CEO of FFD will liaise with MPE regarding the applications received from SOEs.

c) The Deputy CEO of FFD shall convene to the PDMC to:

- Verify the completeness and compliance of the application.
- Ensure alignment with debt limits and sustainability.
- Conduct a credit risk assessment.
- Assess whether on-lending is necessary and cost-effective.
- Request the Attorney General to prepare a legal opinion.
- PDMC's approval of recommendation shall then be submitted to the Minister for endorsement.
- Request is submitted to Cabinet with approved recommendations for information and to note. Unless the loan amount requested exceeds the limit set forth in section 3.1 the approval of Cabinet shall be sought.

4.4 DECISION MAKING AND NOTIFICATION

4.4.1 The Deputy CEO of FFD shall prepare a report through an internal memo summarizing their assessment and the results of the credit risk analysis, along with a recommendation on whether the application for a loan request should be approved. The process will proceed as follows:

a) The report shall be sent to the Minister of Finance through the CEO.
b) The Minister, after considering the recommendation, may approve or disapprove the request.
c) The Minister's decision will be communicated, through the CEO, to the Deputy CEO of FFD.
d) The Deputy CEO of FFD will prepare a Cabinet paper, which will be submitted by the CEO for Cabinet Ministers' information unless loan amount request exceed the limits in section 3.1.
e) Following Minister's approval or disapproval, the CEO will provide feedback to the requesting entity, and in the case of SOEs with a copy to the Ministry of Public Enterprises.
f) After the terms of the primary loan agreement between Government and the creditor have been negotiated and agreed, FFD shall draft a subsidiary loan agreement and initiate negotiations with the public or private company and shall share the draft SLA with the Attorney General to prepare a legal opinion

g) Signing of the subsidiary loan agreement will occur after Government signs the main agreement.

h) The Office of the Attorney General will be required to provide a legal opinion on the subsidiary loan agreement.

i) The Minister will inform the Legislative Assembly of the decision after Cabinet approval or disapproval.

j) FFD shall document its decision-making process and periodically review the evidence to improve future decisions and the overall framework.

5. RECORDING, MONITORING AND REPORTING

5.1 RECORDING

5.1.1 FFD shall be responsible for the registration and recording of all data pertaining to the on-lending transaction in the debt management information systems and be custodian of physical records. In collaboration with other parties, FFD shall reconcile and validate the data at least once per year.

5.2 MONITORING

5.2.1 FFD in coordination with the lenders and on-lending beneficiaries shall be responsible for monitoring the risk status of the on-lent loans, disbursements, payments due, actuals, invoicing borrowers, timely collection of the fees/receivables, and ensuring the outstanding stock does not exceed the set limits. The FFD shall monitor the utilization of funds, based on the progress report on the utilization of funds that needs to be submitted by the on-lending beneficiaries.

5.3 REPORTING AND DISCLOSURE

5.3.1 FFD in coordination with the lenders and on-lending beneficiaries shall be responsible to ensure accurate and timely reporting.

5.3.2 Statements on on-lending shall be reported in the Budget Statement, Quarterly Debt Bulletin, Annual Debt Report, and Public Account Statement and shall be published to the Ministry's website. These documents will ensure transparency and accountability regarding outstanding on-lent loans.

6. EVENT OF DEFAULT

6.1.1 If an on-lending beneficiary detects a potential default situation, it should inform the Ministry (and the Ministry of Public Enterprises, in the case of SOEs) as soon as possible, along with corrective measures proposed.

6.1.2 Upon receiving such notification or occurrence of a default, FFD shall analyse the situation, due diligence with the on-lending beneficiary, and provide advice to the CEO and Minister for Finance. The Minister may consider:

a) activating the collateralization process or,
b) restructuring the terms of the loan to provide the borrower with sufficient time to cure the default

6.1.3 Any restructuring needs to be approved by the Minister.

6.1.4 If restructuring is not approved by the Minister or the collateral remains insufficient, the Ministry shall require full repayment of the outstanding loan, including interest, within a specified timeframe. In such cases, a penalty fee of 0.25 percent shall be imposed on the outstanding amount as per section 3.4.2.

6.1.5 Monitoring of the receivables arising from the defaults and taking recourse actions for the collection of these receivables will be carried out by the FFD.

7. CREDIT RISK ASSESSMENT METHODOLOGY FOR ON-LENDING

7.1 METHODOLOGY

7.1.1 Credit risk assessment will be employed to evaluate the creditworthiness of prospective on-lending beneficiaries in terms of the likelihood of them repaying the loan. To this end, credit risk assessments methodology for on-lending shall apply the Altman Z''-Score. If need be, a Simple Scenario Analysis to evaluate the borrower's financial health and project risks can also be conducted.

7.2 ASSESSMENT

7.2.1 The Altman Z''-Score shall be used for the assessment of historical and projected financial data. In that regard, a set of financial ratios will be derived from financial statements and combined into a weighted formula and will be compared with the benchmark values. In addition, a Scenario analysis shall be conducted to evaluate different risk outcomes, ensuring benefits outweigh risks before proceeding with the on-lending.

ANNEX 1 – ROLES AND RESPONSIBILITIES IN THE GOVERNANCE AND INSTITUTIONAL FRAMEWORK

Ministry of Finance – Minister, CEO, and Financial Framework Division (FFD)

- **Responsibility**: The Ministry of Finance, through the Minister, CEO, and Financial Framework Division, oversees the overall implementation, monitoring, and evaluation of the government on-lending policy.
- **Roles**:
  (1) Review and approve on-lending requests based on the recommendations and assessments from requested parties.
  (2) Administer government on-lending policy, ensuring compliance with fiscal and legal requirements.
  (3) Ensure proper record-keeping and monitoring of all on-lent funds, as well as the receivables that might arise from defaults.
  (4) Conduct risk assessments, including credit risk evaluations, of borrowers seeking on-lending.
  (5) Provide guidance on the risk limits for on-lending and ensure limits are adhered to.
  (6) Review and report on the performance of on-lending beneficiaries, ensuring that outstanding on-lent loans do not exceed prescribed limits.
  (7) Ensure the loan meets the requirements stipulated in the SLA, including adequate documentation and terms.
  (8) Monitor the repayment schedule and, if relevant, notify the CEO and Minister of any potential default situations by the on-lending beneficiary.
  (9) Collaborate with the relevant parties to resolve any issues and mitigate risks associated with the subsidiary loan agreement.

(10) Provide timely access to the CEO and Minister on relevant financial and loan performance information, as required for monitoring and risk management purposes.

Public Debt Management Committee (PDMC)

- **Responsibility**: The PDMC plays a key role in advising on debt management and ensure only the creditworthy borrowers will receive a positive technical recommendation.
- **Members**: CEO (Chairperson), Deputy Governor – NRBT (Deputy Chair), Manager Research (NRBT), Deputy CEO – Budget, Deputy CEO – Economic and Fiscal Policy, Deputy CEO – Treasury and Deputy CEO – FFD (Secretariat) and other members as required.
- **Roles**:

(1) Ensure that the government's fiscal stability is maintained by evaluating the impact of on-lent loans on the public debt portfolio.

(2) Recommend whether to approve or deny any on-lending request based on financial and economic factors.

Cabinet

- **Responsibility**: Cabinet is responsible for providing the final approval for on-lending based on recommendations from the Ministry.
- **Roles**:

(1) Review and approve on-lending proposals submitted by the Ministry.

(2) Consider the broader economic and fiscal implications of approving or rejecting on-lending.

Ministry of Public Enterprises (MPE)

- **Responsibility**: The Ministry of Public Enterprises (MPE) oversees state-owned enterprises (SOEs) and ensures their compliance with the conditions in the subsidiary loan agreement.
- **Roles**:
  (1) Convey to the Ministry the on-lending requests of SOEs.
  (2) Ensure that SOEs seeking on-lending meet the necessary operational and financial criteria.
  (3) Collaborate with the Ministry in providing regular reports on the performance of SOEs which benefit from on-lent loans.
  (4) Advise on the financial health and management of SOEs to mitigate risk to the government.

Attorney General

- **Responsibility**: The Attorney General is responsible for ensuring that primary loan agreements and subsidiary loan agreements comply with legal standards and are enforceable.
- **Roles**:
  (1) Review and provide legal opinions on the primary loan agreements and subsidiary loan agreements to ensure its legality and compliance with the law.
  (2) Advise the Ministry on legal risks associated with on-lending.
  (3) Assist in legal actions, if required, for the recovery of funds in the event of a default by an on-lending beneficiary.

On-lending Beneficiary (Borrower)

- **Responsibility**: The on-lending beneficiary is responsible for submitting a formal request for an on-lent loan, providing all necessary documentation (e.g., financial statements, project details, and business case), and adhering to the terms and conditions of the subsidiary loan agreement.
- **Roles**:
  (1) Maintain accurate financial records and provide periodic reports to Ministry as required.
  (2) Ensure the proper use of borrowed funds according to the agreed purpose outlined in the on-lending request.
  (3) Service the on-lent loan as per signed subsidiary loan agreement between the Borrower and the Government
  (4) Notify the Ministry (and the MPE, if the on-lending beneficiary is an SOE) in case of any financial distress or potential default situations.