Summary of the Report of the Technical Committee on State Government Guarantees

CONSTITUTION OF THE COMMITTEE

In a meeting of the State finance secretaries with the Reserve Bank of India, on November 8, 1997, the issue of government guarantees was deliberated upon at length and the view taken was that, in the interest of prudent financial management and the credibility of the guarantees issued, there is a need for a policy on guarantees for each State government within certain national parameters. The finance secretaries requested RBI to constitute a Technical Committee to examine the issue of State government guarantees in all its aspects. The Committee consisted of finance secretaries from *Gujarat, Jammu and Kashmir, Karnataka, Maharashtra, Meghalaya, Punjab and Uttar Pradesh. Ministry of Finance, Government of India* was also represented in the Committee. The Chief General Manager (CGM) of Internal Debt Management Cell of RBI was the convenor.

BACKGROUND

The States have been providing guarantees for facilitating the flow of funds to the priority sectors, state public sector enterprises, developmental institutions and local bodies, for commercial as well as non commercial activities and urban development. The growing need for infrastructure at the State level and the recent initiatives to invite participation by the private sector in such projects requiring huge investments, has put further demands on State governments to stand guarantor for such projects. There is also increasing recourse to letters of comfort, having the character of government guarantee. The element of risk associated with such guarantees, transparency with regard to the guarantee policies and present magnitude of guarantees extended by the State governments have raised concerns regarding the optimal or sustainable level of such guarantees. In absolute terms, the outstanding guarantees increased from Rs. 40,318 crore in March 1992 to Rs. 79,625 crore in September 1998 representing an annual compound growth of 12.0 per cent. The growth in guarantees particularly since 1995 have been significant, the annual growth rate between March 1995 and September 1998 was 13.1 per cent whereas the growth in debt during the same period was 7.5 per cent. Guarantees accounted for 30 per cent of consolidated fund of all States in March 1996 and 46 per cent of revenue receipts in March 1997.

TERMS OF REFERENCE

Terms of Reference adopted by the Committee were as follows:

(a) Prescribing limit on guarantees - the basis and parameters therefore;

(b) Ensuring greater selectivity in calling for and providing of guarantees;

(c) Honouring of guarantees;

(d) Disclosure and transparency in reporting guarantees including letters of comfort, structured payment arrangements, escrow and direct debit mechanisms;

(e) Standardisation of documentation; and

(f) Guarantee fee and institution of Contingency Fund for guarantees.

RECOMMENDATIONS OF THE COMMITTEE

The recommendations of the Committee are summarised below.

Ceiling on guarantees

In the interest of ensuring fiscal sustainability and ensuring more discrimination and selectivity in the matter of taking and giving of guarantees, it will be desirable for State Governments to fix a ceiling on guarantees and such a ceiling will have transparency, sanctity and operational relevance only if legislated, as explicitly enabled in the Constitution of India. This is being practised already in some States where an overall ceiling on guarantees is legislated, and such ceilings are changed by legislative amendments.

Parameters and basis for the ceiling on Guarantees

There could be ***four*** parameters that could be used for fixing the ceiling on guarantees.

(a) One approach is to link guarantees to a dynamic variable such as Net State Domestic Product (NSDP). Total outstanding debt plus one-third of outstanding guarantees should not exceed, say, 50 per cent of the NSDP. A modification of this parameter is suggested for those States, where guarantees have been used to raise resources for infrastructure, so as to give equal weight to guarantees and debt, for guarantees issued since 1994-95.

(b) The second approach is based on the argument that the NSDP is not a parameter that is within the ambit of the budgetary management of the State governments and it is more appropriate to link guarantees to revenue receipts. Refining this approach further, each State Government could work out the flexible cash available with it each year after deducting the obligatory expenditure such as salary, pension, amortisation and interest payments from the Central tax devolution, States own tax revenues and non tax revenues. Depending on the maturity pattern and nature of the loans guaranteed and using the same equation of debt to guarantee as under the first parameter, the likely outflows on account of guarantees, letter of comfort, tripartite payment agreements, escrow accounts etc., could be worked out and then related to the coverage available against the flexible cash flow. A coverage of 10 : 1 should be maintained over the period of the loans/guarantee. The net present value concept could be incorporated in this approach.

(c) The third approach is to link the guarantees and debt to the consolidated fund itself. Thus, the parameter would be that guarantees plus debt together do not exceed twice the receipts in the consolidated fund.

(d) The fourth approach is to ensure that the ratio of incremental guarantees to incremental net market borrowings is kept constant or brought down.

There should be sufficient flexibility to each State Government to choose the most

appropriate parameter while ensuring transparency in respect of all the parameters. While each state may legislate on the ceiling on guarantees, it should have the freedom to choose any of the parameters listed above to serve as the basis for fixing the ceiling. Simultaneously, there is advantage in reporting to the legislature the extant position in terms of each of the four parameters.

Selectivity in calling for and providing of guarantees

The proposal for prescribing a ceiling on guarantees is practical only if there is more selectivity in the calling for and in providing of guarantees. Such selectivity can be practised, *inter alia*, in the following ways:

(a) Each State may lay down the procedures to be followed in case of projects or units where State guarantee is involved, identifying a nodal officer in the Finance department, who could co-ordinate the proposals involving guarantees. It will also be in the interest of banks and financial institutions to involve the Finance Departments in any financial arrangement involving the provision of guarantee by State Governments.

(b) Some degree of risk sharing between the lenders/investors, borrowers and State Government is desirable in the interest of ensuring efficient utilisation of funds and financial discipline. Instead of State Governments providing guarantee for 100 per cent of the loan/bond, guarantee could be restricted to 75 per cent to start with and adjusted suitably depending upon the project with the concurrence of the investor/lender.

(c) States may give immediate attention to finalisation of the audited accounts of State public sector enterprises in order to minimise the cases where guarantees are required.

(d) Where State level housing and urban development agencies do not have clear title for the immovable properties owned /held by them, the States could explore the possibility of creating a deed of transfer similar to that executed by the Government of Tamil Nadu, to obviate the need for guarantees especially in favour of Housing and Urban Development Corporation (HUDCO) and Life Insurance Corporation of India (LIC) for housing loans and for loans to develop urban property especially for commercial purposes.

(e) In the interest of ensuring better selectivity in the matter of giving guarantees, National Bank for Agriculture and Rural Development (NABARD), the finance and the cooperation department of the State Government should together formulate a plan based on historical default at various levels, to minimise the need for provision of guarantees. The possibility of introducing a system of 'risk sharing' between the State Government, NABARD and the cooperative bank could also be considered.

(f) Amendment to the National Cooperative Development Corporation (NCDC) Act, removing the mandatory requirement of guarantee, may be expedited. In sanctioning loans, NCDC could be governed more by the viability of the project assisted and the financial position of the cooperative assisted so that the need for guarantee is automatically obviated. As in the case of NABARD, introduction of a system of risk sharing could be thought of.

(g) The reasons for asking for guarantee could be given in writing by the banks and financial institutions to the Finance Secretary, who could either justify the intrinsic viability or take steps to improve the viability.

(h) Even for non-commercial projects requiring guarantees, States will need to evolve arrangements for increasing the stake in such projects by each of the stake holders viz., the beneficiaries, the Government and the financial institutions.

(i) In case of infrastructure projects there could be greater selectivity in the matter of calling for and providing of guarantees. Where guarantees are given for infrastructure projects, there should be some accountability for implementation and milestones could be drawn up for monitoring. The availability of guarantee must not lead to a feeling that the bonds/ borrowings backed by such guarantee do not have to be serviced by the project itself.

(j) At present, once guarantees are given, there is no review as to whether they need to be continued if the project has attained viability. States could consider phasing out of guarantees in concurrence with financing agencies/rating agencies/ trustee on behalf of bond holders as and when the projects achieve viability. To reach this objective, milestones could be specified for each project which could be monitored; on reaching the milestone, the guarantee could be phased out or extent of risk covered by the guarantee reduced.

Honouring of guarantees

It is in the interest of State Governments to ensure that all guarantees in respect of loans and bonds are immediately honoured whenever there is default. The manner in which the States handle the issue of default in honouring of guarantees will play a very important role in ensuring the success of their market borrowing programme. If necessary, as has been done by some States, RBI could be authorised to earmark or pre-empt a portion of the new loans towards the arrears in payment of interest and principal on loans and bonds. Alternatively, special bonds could be issued to banks and financial institutions in lieu of the accumulated arrears of payment due from State governments under invoked guarantees. Each bond issued could be limited to the specific amount of guarantees invoked by the bank/financial institution concerned, based on market-related interest rate so that such bonds could be also traded in the secondary market. Both these measures should be viewed as exceptional one time measures so as to avoid moral hazard.

Letter of Comfort

As there is an implicit liability arising out of a letter of comfort and there is a need to contain contingent liabilities devolving upon it, State government may eschew the practice of providing letters of comforts and where letter of comfort from State government is required, credit enhancement may be provided through explicit guarantees within the overall limit fixed for the purpose. As regards letters of comfort provided in past, full details may be disclosed in the budget documents and may be included in reckoning the ceiling on guarantees.

Disclosure transparency and reporting of guarantees

Comprehensive information on guarantees as also letters of comfort wherever issued

should be disclosed by the State governments in the major budget document i.e., Budget at a Glance on as contemporaneous a basis as possible.

The proposal for ceiling on guarantees using whichever parameter the State government feels is appropriate for it, should be brought to the legislature before the next year's budget formulation exercise say, by September, so that the ceiling can be debated and legislated upon.

Automatic debit mechanisms

Mechanisms providing for automatic debit of State Government accounts run the risk of there being insufficient funds relative to such preemption and minimum obligatory payments such as salaries, pensions, amortisation and interest payments. Reservations have also been expressed to such arrangements on other grounds as well. Debit amounting to expenditure has to be authorised by State legislature in its budget and such automatic debits being uncertain cannot be specifically authorised. Recourse to automatic debit mechanisms should therefore be subjected to great circumspection.

Tripartite Structured Payment Arrangements

Structured payment arrangements provide mechanisms for assured payment by State Governments even where there is no guarantee whereas under guarantees issued by the State governments there is no such mechanism. Such arrangements should be discouraged as the financing decision is then not based on the intrinsic viability of the project but the availability of such assured payment arrangement. Simultaneous with prescribing a ceiling on guarantees and ensuring selectivity in issuing guarantees, such structured payments should be included in the guarantees reported and subject to the limits fixed by the States.

Escrow mechanisms for Independent Power Projects (IPPs)

State governments should encourage the State Electricity Boards to build up a risk fund to handle the contingent liability on account of exchange risk under escrow account arrangements provided to IPPs. Along with disclosure of guarantees, States should also disclose the revalued liabilities of the State Electricity Boards under IPPs or similar arrangements for other utilities.

Standardisation of documentation

Standardisation of guarantee documents though desirable would be difficult. Each State government could, however, evolve its own standard documentation for guarantees.

Guarantee fee and constitution of a Contingency Fund for guarantees

Normally, the guarantee fee should be so structured that the receipts from such fees will take care of the devolvement. Guarantee fees should be invariably charged, appropriately calculated and properly accounted for. The charging of guarantee fee should be rationalised and each State should set up a contingency fund or make some provision for discharging the devolvement under guarantees. The fees collected should be credited to the fund set up for the purpose.

Monitoring of Guarantees

As part of exercises leading to budget, Committee recommends that guarantees given by

State governments may be made a regular item of discussion during the annual plan discussion, specifically at the stage of resource mobilisation exercise.

Implicit Contingent Liabilities

In line with the trend towards consolidated presentation of accounts, the Committee recommends that a summary of the financial statements of 100 per cent State-owned corporations may form part of the notes relating to budgets of the State governments.