

CHAPTER 1

INTRODUCTION

Constitution of the Committee

1.1 In a meeting of the finance secretaries of State Governments with the Reserve Bank of India (RBI), 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 in their deliberations noted that initiatives for ceilings on guarantees had already been taken in some States. Nevertheless, many States felt the need to take similar initiatives. Furthermore, ensuring a responsible guarantee policy and honouring of guarantees once issued were of paramount importance. 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 made the convenor. Director, National Institute of Public Finance and Policy was a special invitee.

Terms of Reference

1.2 On the basis of the discussions in the above meeting of finance secretaries and the deliberations during the course of the Seminar on “*Cash Management Techniques*” organised by RBI on January 31 and February 1, 1998 for the finance secretaries of State governments at Mumbai, the *Terms of Reference* adopted by the Committee were as under :

- (a) To assess the quantum of guarantees issued/being issued by the State governments for various purposes and the impact of such guarantees on the finances of State governments.
- (b) To review the track record in honouring guarantees issued by State governments.
- (c) To assess the guarantees issued by the State governments from prudential angle by banks and financial institutions.
- (d) To assess the feasibility of –
 - fixing a limit on the quantum of guarantees that can be issued by a State government similar to that of Gujarat;
 - ensuring transparency in reporting guarantees and terms (such as guarantee fees) for such guarantees;
 - laying down the mechanism to ensure the prompt honouring of guarantee issued by the State governments;

- (e) To assess the implications of foreign exchange component in regard to such contingent obligation, especially in the guarantees offered in the power sector.
- (f) To assess the States' *support arrangements*, including letters of comfort to an enterprise/agency to enable it to discharge loan obligations, thus enabling rating agencies to treat them as guarantees.
- (g) To assess the possibility of prescribing a legal ceiling on such guarantees and criteria for fixing a ceiling.
- (h) To assess the importance of attaching weights to risks and arriving at risk weighted guarantee limits.
- (i) To review the practice of public sector enterprises for insisting on giving guarantees.
- (j) To review the level of guarantee fee.
- (k) To assess the scope for formal legislative approval for contingent liabilities as in the case of other liabilities.

Background

1.3 The initiation of fiscal consolidation process at the Centre and further shift in the focus at the State level has brought the issues of reduction in fiscal deficit and public debt as an integral element of the overall programme of economic reforms. There has been a shift to market related rates of interest on borrowings by not only Central government but also State governments. Apart from deficit and debt, an issue that has significant implication for the sustainability of the fiscal position, is that of providing State guarantees. The States have been under pressure to provide 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 need for participation by the private sector in such projects requiring huge investments, has put further pressure on State governments to stand guarantor for such projects. There is also increasing use of letters of comfort and structured payment arrangements, having the character of government guarantees. The element of risk associated with such guarantees/arrangements, 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 keeping in view the financial health of State governments.

1.4 While guarantees do not form part of debt, as conventionally measured, these have, in the eventuality of default, the potential of exacerbating an apparently sound fiscal system. Thus, a meaningful analysis of guarantees issued by States would also require an assessment of the State finances, particularly, the debt burden and related issues.

Approach of the Committee

1.5 On the basis of the *Terms of Reference* adopted by the Committee, the broad issues addressed by of the Committee were as follows :

- (a) Prescribing limit on guarantees- the basis and parameters therefor.
- (b) 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.
- (f) Guarantee fee and Contingency Fund for guarantees.

The Committee had *three* meetings in Mumbai. The third meeting of the Committee was preceded by a meeting with the financial institutions and banks.

Relevance to Central Government

1.6 During the deliberations, there were several occasions when the issue of relevance of the recommendations to Government of India came up. The Committee noted that the conceptual issues are the same, constitutional provisions are similar and procedural detail and policies on guarantees are common. However, since the Committee was enjoined upon to consider only the issues relating to State government guarantees, it confined its recommendations only to the States, though consideration may be given to transmit the Report to Government of India to take a view in the matter.

Structure of the Report

1.7 After the *Introductory Chapter*, the conceptual issues are addressed in *Chapter 2*. The salient features of State government guarantees including the dimensions thereof are presented in *Chapter 3*. The issues addressed by the Committee and the recommendations thereon are elaborated in *Chapter 4*. *Chapter 5* contains the executive summary. *Annexure 1* contains a list of persons associated in the work of the Committee.