Chapter 4 : Issues and Recommendations

4.1 In the light of the discussions in *Chapter 2* and *Chapter 3*, the following issues are addressed by the Committee.

- Ceiling on guarantees
- Parameters for fixing ceiling
- Selectivity in the calling for and providing of guarantees
- Honouring of guarantees
- Disclosure transparency reporting and monitoring of guarantees including letters of comfort and other assured payment arrangements
- Guarantee fees and contingency fund for guarantees.

4.2 The issues addressed by the Committee and recommendations thereon are discussed below :

Ceiling on Guarantees

4.3 The first issue before the Committee was whether there should be a ceiling on guarantees; further whether such a ceiling should be legislated by the State or whether it should be a self imposed voluntary ceiling or whether it could be imposed by the Central government as a pre condition for giving consent to borrowing by the States concerned.

4.4 The general consensus in the Committee was that there should be a ceiling on guarantees. Under Article 293(1), a State can give guarantees upon the security of the Consolidated Fund of the State; in other words implicitly there is a ceiling in terms of the Fund itself. While Article 293 provides a legal basis for a ceiling it does not have much operational significance as the consolidated fund is a fluid concept and goes on changing. While prescribing a ceiling, it is equally important to recognise the pressure on State governments to give guarantees especially for private financing of infrastructure projects. In this context, it is essential that financial institutions do not ask for guarantees as a matter of routine. It emerges that IDBI, ICICI and commercial banks have for some time now, eschewed the practice of insisting on guarantees unless they are required to provide additional funds and the viability of the unit is in jeopardy. Even in such cases the intrinsic viability is assessed and decision taken on commercial grounds and in many cases one time settlement entered into with no further assistance. The guarantees have, therefore, lost their importance in such cases. This trend is borne out by the data, which show that, major part of the guarantees are in favour of LIC, NABARD, HUDCO, NCDC and REC. The major share of guarantees of LIC and HUDCO is in the area of housing, water supply, public utilities and urban development. Unless these institutions are in a position to provide financial assistance for such purposes on a self liquidating viable basis without the comfort of the guarantee, it would be difficult to recommend a ceiling on guarantees which would be practical and consistent with the need for further guarantees in the area of infrastructure. It is also noted that in the last three year, most of the guarantees are on behalf of Special Purpose Vehicles (SPVs) issuing bonds through private placement to financial institutions, banks and other institutional investors. The need for prioritisation in offering such guarantees assumes critical importance. In a sense, the imposition of a ceiling will by itself lead to more selectivity. Therefore, in the interest of ensuring fiscal sustainability and imparting

more discrimination and selectivity in the matter of taking and giving of guarantees, the Committee is of the view that there should be 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.

Parameters and basis for the ceiling on Guarantees

4.5 The second issue relates to the parameters for fixing the ceiling on guarantees. There could be four approaches that could be considered and these are discussed below :

(a) The first approach is to link guarantees to a dynamic variable such as NSDP. The cap could be inclusive of debt with 100 per cent weight for debt and reduced weight for guarantees. Normally, the weight for guarantees should be based on the historical experience of devolvement of guarantees on the State Governments. As many banks and financial institutions do not invoke guarantees even when there is default, invocation in the past cannot necessarily be taken to measure probability of default in the future. The default probability ideally, should also take into account the possibility of recovery of advance. In case of guarantees for public utilities it should be seen whether there is recovery of user charges for the public utilities which has been financed against the guarantee. Each State could make its own assessment of the default probability. Going, however, by the purposes for which guarantees have been given and more so, at an increasing pace, it would appear that a large part thereof would translate into a direct and equivalent charge on the budget. This is particularly so in respect of guarantees on behalf of SPV for undertaking infrastructure expenditure. If the weightage for guarantees is taken as one third, then the first parameter could be that total outstanding debt plus one-third of outstanding guarantees should not exceed say, 50 per cent of the NSDP. The present position using this formula has been worked out in *Table 3*. 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 weightage to guarantees and debt, for guarantees issued since 1994-95. For guarantees issued after 1994-95 the weight may be taken as 100 per cent.

(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 government and it is more appropriate to link guarantees to the revenue receipts. The actual position in this regard is given in *Table 7*. As observed earlier, interest payments as percentage of revenue receipts have increased to about 18 per cent. If debt servicing (amortisation and interest payments) is taken as share of revenue receipts the percentage would be still higher. Refining the 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. The market borrowings and loans from Centre should not be included in the flexible cash flow as it is prudent not to use borrowed funds for the discharge of devolved guarantees**.** 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 annual outflow 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* would ensure that there will be sufficient money left for the government to continue with the development programmes. The net present value concept could also be incorporated in this approach.

(c) The third approach is to link the guarantees and debt to the consolidated fund itself. The parameter would be such that guarantees plus debt together do not exceed twice the receipts in the consolidated fund with the caveat that the guarantees by themselves would in any case be subject to Article 293 i.e., not to exceed the consolidated fund. The actual position in this regard is given in *Table 4*.

(d) The fourth approach is to ensure that the ratio of incremental guarantees to incremental net market borrowings is kept constant or brought down. The actual position in this regard is given in *Table 2*.

4.6 The Committee is of the view that 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. There is, however, great advantage in reporting to the legislature the extant position in respect of each of the four parameters.

Selectivity in the calling for and providing of guarantees

4.7 As mentioned earlier, the proposal for a prescribing a ceiling on guarantees is practical only if there is more selectivity in the calling for and in providing of guarantees. An important requirement in this regard is that the Finance Departments should be involved in any project /scheme involving State government guarantees from the very beginning. Very often guarantees become a matter of *fait accompli* to the Finance Department which is then not able to exercise the selectivity involved in adhering to any ceilings that may be fixed. The Committee recommends that 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. As the budget provision for honouring of guarantees will be made eventually by the Finance Department, the Committee is of the view that it will be in the interest of banks and financial institutions to involve the Finance Departments in arrangements involving the provision of guarantee by State Governments from the very beginning.

4.8 Looking at the trend in the guarantees and the nature of guarantees in the past, the need for greater selectivity in the future in the context of adhering to a ceiling, and in the interest of efficient utilisation of funds and financial discipline, the Committee is of the view that some degree of risk sharing by the financing bank/institutions is desirable. In this context, the Committee recommends that instead of State governments providing guarantee for 100 per cent of the loan/bond, such guarantee could be restricted to say 75 per cent to start with. Depending on the viability of the project, the need to ensure close monitoring by financing bank/institutions, the risk sharing pattern could be adjusted. This will ensure financial discipline on the units on whose behalf guarantee is being issued, greater cap and follow up by the banks/financial institutions, as also minimise ‘moral hazard’ involved in issuing guarantees.

4.9 In several cases, it was observed that the financing bank/financial institution ask for guarantees on behalf of public sector enterprises as the accounts of the latter have not been finalised or audited for several years together. It was put before the Committee that availability

of timely audited accounts would enable the banks/financial institutions to extend financial assistance and with an assessment of the financial conduct of the public sector enterprise as reflected in the accounts, guarantees could be obviated. The Committee, therefore, recommends that 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.

4.10 While classifying the nature of guarantees it is observed that other than guarantees taken by NABARD and NCDC, the major portion of guarantees are on account of the electricity boards, road transport corporations or for housing and urban development in favour of predominantly HUDCO and LIC. In the case of housing the Committee was informed by the HUDCO and LIC that if a State Housing Agency/Board has a clear and marketable title which can be mortgaged, State guarantee is not insisted upon. Most housing boards and developmental authorities are handicapped in the creation of mortgage by deposit of title deeds (equitable mortgage) of their properties due to non availability of documents of title as mostly the lands owned by them were acquired under the Land Acquisition Act 1894. About 20 years back HUDCO and Government of Tamil Nadu had developed a deed of Transfer to create a document of title for lands acquired under the Land Acquisition Act . This deed is executed by the Government of Tamil Nadu for the land acquired by the Government of Tamil Nadu under the provisions of the Land Acquisition Act 1894 and for which no clear documents of title are available. Upon execution of the deed of transfer the lands acquired are conveyed assigned and transferred to the Housing Boards or other state agency absolutely and forever. The deposit of this title deed facilitate the creation of mortgage. The Tamil Nadu Government has exempted such deeds from payment of stamp duty and registration charges. A copy of the deed of transfer executed in 1977 is at *Annexure 2*. The Committee recommends that 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 for housing and urban development schemes for MIG, HIG and commercial projects. This could facilitate in eliminating guarantees in favour of HUDCO and LIC for housing loans and for loans to develop urban property especially for commercial purposes.

4.11 NABARD (NB) as a single institution accounts for the largest share of guarantees issued by State governments. Prior to the formation of NB the credit facilities were provided to State Co-operative banks by RBI under the relevant provisions of RBI Act mostly against State Government guarantee. At the time of formation of NB similar provisions were made in NB Act in regard to obtention of State government guarantee in the case of co-operative banks. Co-operation being a State subject, historically the objective of making provisions in the RBI /NB Act and insistence on State government guarantee earlier by RBI and now by NB was to ensure that the State government takes active interest in the good governance and working of co-operative institutions so that their financial position is not adversely affected and operational efficiency maintained . Moreover, many of the borrowing institutions may not be able to merit sanction of the loans to the required extent solely on their financial strength and therefore government guarantee enables these institutions to secure higher refinance from NB for meeting the genuine requirements for agriculture and rural development. NB does not take any guarantees in case of refinance to commercial banks and RRBs.

4.12 It is a moot point whether insistence on guarantees by NB has made State governments take more active interest in ensuring good governance in co-operative institutions. Also such insistence does not seem to have led to improved financial position or operational efficiency. A view could well be taken that the availability of guarantee in itself encourages the default culture and results in erosion of the financial position in the various tiers in the co-operative structure. In the interest of ensuring better selectivity in the matter of giving guarantees in favour of NABARD, the Committee recommends that State finance and co-operation department should together formulate a plan in consultation with NABARD, based on historical default at various levels, to minimise the need for provision of guarantees. As part of the plan the possibility of introducing a system of 'risk sharing' as suggested above could be considered in that, say, 75 per cent of the risk of default could be covered by the State government guarantee with 25 per cent of the risk of default borne by NB. The risk sharing by the State government could progressively decline.

4.13 What is true of NB is equally applicable to NCDC. NCDC is a statutory corporation established under NCDC Act 1962 for development of agriculture and allied activities in the co-operative sector. The assistance provided by NCDC is channelised through the State governments. It gives loans to State governments to facilitate their participation in the share capital of co-operative societies. Loans to certain co-operatives are provided directly for modernisation and expansion on the guarantee of the State government. State government guarantee is taken in all cases of assistance because, (i) it is mandatory as per provisions of NCDC Act, (ii) projects relate to agriculture and allied which are more risky, and (iii) financing a co-operative also involves risk. It is learnt that a proposal for amendment in the NCDC Act is under consideration of the Central Government which would enable NCDC to provide financial assistance directly to co-operatives without government guarantees. The Committee recommends that amendment to the NCDC Act, removing the mandatory requirement of guarantee, be expedited and also NCDC be governed more by the viability of the project assisted and the financial position of the co-operative assisted so that the need for guarantee is automatically obviated. As in the case of NB introduction of a system of risk sharing could be thought of by NCDC and the States concerned so that the taking and giving of guarantees is not automatic.

4.14 In so far as banks and financial institutions like IDBI and ICICI are concerned the Committee noted that the practice of obtaining guarantees has been much reduced in the context of liberalisation and greater focus on the inherent viability of the project or unit. In case of advances for working capital and other activities the banks and financial institutions would be well advised to go by their commercial judgement and intrinsic viability of the project. In general, the Committee felt that where the viability was marginal and guarantee is felt necessary, the reasons for asking for guarantee could be could be given in writing by the banks and financial institutions to the finance secretary who could either justify the intrinsic viability to the satisfaction of the banks and financial institutions or make proposals for improving the viability.

4.15 In general, for commercial purposes banks/financial institutions should be guided by the viability of projects. Where non-commercial projects such as those with social objectives are being taken up, guarantees are usually insisted upon by the financing institutions. In such cases,

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.

4.16 In case of infrastructure projects for which there could be an urgent need to provide guarantees, the Committee is of the view that there could be greater selectivity in the matter of asking and giving of guarantees. Despite the availability of State guarantee, it is observed that the cost of finance has been as high as 18 per cent in some cases. The provision of guarantee seems to be more for obtaining the finance in the first place and not for improving the terms on which the finance is obtained thereby improving the viability of the project. The Committee is also of the view that 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. The cost benefit of providing guarantee will need to be worked out by the State government and in all cases of guarantee for infrastructure much more selectivity and prioritisation will need to be ensured if the ceilings on guarantee have to be adhered to.

Phasing out of guarantees

4.17 At present once guarantees are given there is no review as to whether they need to be continued if the project has attained viability. Since there is need for prioritisation, the Committee recommends that States could also consider phasing out of guarantees as projects achieve viability and 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. This should be done with the concurrence of the financing agencies or where the financing is through bond floatation, it could be done in consultation with the rating agency and/or trustee designated on behalf of bond holders as also disclosed in the prospectus.

Honouring of guarantees

4.18 As mentioned in the earlier chapter, there are many cases of default in payment of interest and principal in respect of guaranteed loans and bonds, especially in the case of State Electricity Boards (SEBs) State and Road Transport Corporations (SRTCs). Furthermore, there is default even in case of guaranteed bonds, even those issued under the market borrowing programme. This is a most disturbing trend as the very sanctity of guarantees is questionable if they are not honoured. Financial institutions and banks will be wary of extending any finance to State level bodies or investing in the bonds issued by such agencies even against State government if the guarantees are not honoured. In fact, already banks have been reluctant to subscribe to the State development loans in States where there is a default of interest payment and instalment of principal on guaranteed bonds. Some States have authorised RBI to debit their account whenever a new loan is issued to clear such arrears of payment. This has had a salutary effect and has encouraged banks to invest in the bonds issued by the government or guaranteed by the government in such States. As the new prudential norms become effective, this trend will only be strengthened. There is also a move to switch over gradually to issuing State loans in the market through auction rather than the present system when banks are allocated a certain share of the overall market borrowing programme approved for all State governments. 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. The Committee is of the view that it is in the interest of State Governments to ensure that all guarantees in respect of loans and bonds where there is default are immediately honoured. 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. However, there is need to limit such earmarking or pre-emption and may at best be a one time measure since this procedure is not a positive reflection of prudent financial practices by State Governments.

Issue of Bonds in Lieu of Arrears of Payment

4.19 The banks and financial institutions have a fair amount of funds already locked up in default areas on account of default of interest and principal payments in respect of advances made by them especially towards pre-take over dues and assistance for rehabilitation of sick units as also State guaranteed bonds issued by some State level units. As a clean up operation and with a view to avoiding moral hazard, as a one time measure, States could consider whether Special Bonds could be issued to banks and financial institutions in lieu of the accumulated arrears of payment due 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.

Letters of comfort

4.20 The Committee noted that in several cases the States were issuing letters of comfort to financing banks/institutions, *inter alia*, assuring them that their stake will not be divested till the loans are repaid. Some letters are comfort are more specific. Although not in the nature of explicit contingent liabilities the letters of comfort are in the nature of implicit contingent liability**.** With regard to the distinction between a guarantee and letter of comfort, the provisions of the *Indian Contract Act and Article 299(1)* of the Constitution make it clear that a letter of comfort would not constitute a guarantee. One view was that the nature of wordings used in the letter of comfort would decide whether the letter of comfort would be treated as a guarantee. If the liability devolves on the guarantor, then it becomes a guarantee. The international practice appears to be to treat the letter of comfort as good as a guarantee. The consensus view however is that there is an implicit liability arising out of a letter of comfort. The Committee recommends that, having regard to the need to contain the contingent liabilities devolving upon it, State Government may eschew the practice of providing letters of comfort and where comfort from State Government is required, credit enhancement may be provided only through 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

4.21 The Committee recommends that 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 basis as possible. Institutional arrangements for collection of data, monitoring, analysis, etc., for this purpose may be reviewed. Such arrangements may include carving out in Ministries of Finance at both Union and State levels, public sector (not merely Government) debt and guarantee cells and placing before

Parliament and State legislatures annual status of such public sector debt and guarantees as part of documents connected with the Budgets.

4.22 In the paper on *'Placing a Statutory Limit on Public Debt'* published by the RBI in the RBI Bulletin of December 1997, it was suggested that once a mechanism for placing a limit on public debt is evolved, it should be placed before the parliament/legislature before the budget formulation exercise begins, say before September**.** On similar lines, the Committee recommends that the proposal for ceiling on guarantees using which ever parameter the State Government feels is appropriate for it should be brought to the legislature before the next year's budget formulation exercise so that the ceiling can be debated and legislated upon.

Automatic debit mechanisms

4.23 With a view to encouraging flow of private capital to the power sector, the Central government had agreed to counter guarantee the obligations of State Electricity Boards guaranteed by the State governments for fast track projects. Under such guarantees, there is an automatic debit mechanism for debiting State Government's account for covering the shortfall in the receivables in the escrow account for covering monthly bills, deemed generation and minimum power purchases. The automatic debits, however, have priority over other payments which may be critical. Such mechanisms therefore, run the risk of resulting in insufficient funds for financing minimum obligatory payments such as, salaries, pensions, amortisation and interest payments. Reservations have also been expressed to such arrangements on other grounds as well. Debits, such as these, which amounts to expenditure, it is held, has to be authorised by State legislature in its budget. However, such automatic debits being uncertain cannot be specifically authorised. Without going into the constitutional, legal and procedural aspects, the Committee suggests that recourse to automatic debit mechanisms should be subjected to great circumspection.

Tripartite Structured payment Arrangements

4.24 Certain practices seem to have also developed in the market, on the initiative of credit rating agencies in the interest of ensuring timely servicing of bonds issued by State level agencies for promoting infrastructure financing. Under such structured payment mechanisms, Tripartite agreements are entered into between the State government, the respective Corporation and the respective Trustee to the bond holders. The Corporation has to ensure that 45 days prior to every due date, a certificate from the bank confirming availability of adequate funds for servicing of bonds would be sent to Trustee. In case the bank is not in a position to give the certificate, the State government undertakes to transfer funds to the designated account. Such arrangement have been entered into by *Maharashtra, Gujarat, Karnataka and Andhra Pradesh* and makes such arrangements even better than guarantees although not explicitly/legally termed as 'guarantees'. Such arrangements provide the basis for an enhanced rating given by the credit rating agency. The Committee is of the view that such structured payment 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. The Committee recommends that 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 State.

Exchange risk under escrow arrangements

4.25 Under escrow arrangements for IPPs, the exchange risk passes through to the consumer but the IPP is assured of the payment from the SEBs whether the latter recovers the same from the consumer or not. The exchange risk on the debt is also borne by the SEBs although theoretically there is a pass through mechanism to the consumer. The contingent liability on the State governments on account of such escrow account arrangements can be quite significant and is difficult to quantify. Ideally there should be some degree of hedging by the SEBs of at least the exchange risk if not by actually going in for a forward cover but by creating a risk fund which is separately invested in identifiable secure investments. The Committee recommends that 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. The Committee also recommends that together with disclosure of guarantees, State should disclose the revalued liabilities of the SEBs under IPPs or similar arrangements for other public utilities.

Standardisation of documentation

4.26 The Committee observed that there is no uniformity among the State Governments while providing a guarantee. The documents vary according to the specific need of the banks / financing institutions and the Committee is, therefore, of the view that standardisation of guarantee documents would be difficult and not necessarily very practical. The States may however evolve standard documents for their use.

Guarantee fee and constitution of a Contingency Fund for guarantees

4.27 Normally, the guarantee fee should be so structured that the receipts from such fees will take care of the devolvement. This is not practical for three reasons. First, the fee is not linked to the risk. Second, many all India institutions do not allow the collection of fees as they make it a precondition for the loan. Third, many of the State agencies even default in the payment of the fees. The Committee recommends that in all cases of guarantee, guarantee fee should be charged even if it is for a non-commercial or welfare activity. This is to ensure that all guarantees are accounted for and comprehensive information available to the Government. Furthermore, the Committee is of the view that charging of guarantee fee should be rationalised and each State should set up a contingency fund or make some provision for discharging the devolvement. The fees collected should be credited to the fund set up for the purpose.

Monitoring of Guarantees

4.28 With a view to review the giving of Government guarantees and monitoring the levels of contingent liabilities that the State Governments may be acquiring, the 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. At this stage, the total exposure of State Government by way of Government guarantees could be discussed. While discussing resources of State Public enterprises specific prudential limits for Government guarantees may be discussed in detail. This could be a pre-condition for giving consent to borrowing by the State concerned.

Implicit Contingent Liabilities

4.29 While the Committee has focused its attention on explicit contingent liabilities in the nature of State government guarantee, it would like to draw attention to one category of implicit contingent liabilities, *viz.,* borrowings from banks and non-banking sources by 100 per cent State-owned enterprises such as, SEBs, SRTCs, etc. As a part of increasing transparency and in line with the trend towards consolidated presentation of accounts, the Committee recommends that the audited financial statements of 100 per cent State-owned corporations may form part of the published accounts of the State government.