Guidelines on State Guarantees on Borrowings

For Prelims: RBI's Guidelines on State Guarantees on Borrowings, Reserve Bank of India (RBI), Indian Contracts Act, 1872.

For Mains: RBI's Guidelines on State Guarantees on Borrowings.

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Why in News?

Recently, a Working Group constituted by the **Reserve Bank of India (RBI)** has made certain recommendations to address issues relating to **Guarantees extended by State governments.**

- The Working Group constituted during the 32nd Conference of the State Finance Secretaries held in July 2022.

What Constitutes a Guarantee?

- **About:**
  - A 'guarantee' is a legal obligation for a State to make payments and protect an **investor/lender from the risk of default by a borrower.**
  - A guarantee, as per the **Indian Contracts Act, 1872**, is a contract to "perform the promise, or discharge the liability, of a third person in case of his default. It involves three parties: **the principal Debtor, Creditor, and Surety.**
    - **Creditor:** The entity to whom the guarantee is given. This is the party to whom the **payment is due**, and they are protected by the guarantee.
    - **Principal Debtor:** The entity on whose **behalf the guarantee is given.** This is the **party that owes a debt** or has a liability.
    - **Surety:** The **entity providing the guarantee** (State governments in this context), that **promises to perform the promise** or discharge the liability of the **principal debtor in case of default.**
      - The surety undertakes a legal obligation to perform the promise or discharge the liability of the **principal debtor if they default.**
  - A guarantee must not be confused with an **'Indemnity'** contract that protects the lender from loss caused to them by the conduct of the promisor (or the principal debtor).
- **Illustration:**
  - If **A delivers** certain goods or services to B and B does not make the **agreed-upon payment**, B is defaulting and at the risk of being sued for the debt.
  - C steps in and promises **that s/he would pay for B.** A agrees to the forbear request. C's action constitutes a guarantee.
- **Purpose of a Guarantee:**
  - At the state level, guarantees are commonly used in three situations.
    - **Seeking Concessional Loan:** When **seeking concessional loans** from bilateral or multilateral agencies for public sector enterprises, a **sovereign guarantee** is

often required.
    - **To Enhance the Viability of Projects:** Guarantees are employed to enhance the viability of projects that **promise significant social and economic benefits.**
    - **To Secure Resources at Lower Interest:** Public sector enterprises may use guarantees to secure resources at lower interest rates or more favourable terms.
- **Risk With the Guarantees:**
  - The use of guarantees, while convenient in good times, poses **fiscal risks**.
  - According to the report by the working group, one of the reasons why the instrument has been widely used is that an **upfront cash payment is usually not required in case of guarantees.**
  - This **practice can lead to unforeseen cash outflows** and **increased debt for the state,** especially as guarantee triggers and associated costs are often challenging to estimate.
  - State governments are **often obligated to grant guarantees on behalf of various entities** like state-owned enterprises, cooperative institutions, and urban local bodies **to secure loans from commercial banks** or financial institutions.
    - In return, these entities **pay a guarantee commission or fee to the state government.**

What are the Key Recommendations of the RBI Working Group Regarding Guarantee?

- **Definition of Guarantee:**
  - The term Guarantee should be **used in a broader sense** and include all instruments **if they create an obligation on the guarantor (State) to make a payment on behalf of the borrower** at a future date.
  - Further, it must **make any distinction between conditional or unconditional, or financial or performance guarantees** in order to assess the fiscal risk.
    - These are conditional liabilities that may present **a potential risk in the future.**
- **Guarantees only for the Principal Loan:**
  - The government guarantees **should not be used to obtain finance** through State-owned entities, which substitute budgetary resources of the State Government.
    - Additionally, they should not be allowed to **create direct liability/de-facto liability on the State.**
  - There should be **adherence to Government of India guidelines** that stipulate that **guarantees be given only for the principal amount** and normal interest component of the underlying loan.
  - Guarantees must not be extended for **External Commercial Borrowings,** must not be extended for **more than 80% of the project loan** (depending on the conditions imposed by the lender) and must not be provided to private sector companies and institutions.
  - Appropriate preconditions such as the **period of guarantee, levy of (guarantee) fee to cover risk, government representation on the management board of the borrowing entity,** and right to audit, etc, must be specified.
- **Risk Determination, Fee and Ceiling:**
  - The Group recommends that **States assess the risk associated with guarantees** by categorising them **as high, medium, or low risk**, taking into account the **entity's past default history.**
    - The methodology used for assigning these risk weights should be transparent and disclosed.
    - Based on the risk assessment **minimum guarantee fee must be set at a minimum of 2.5% per annum.**
  - The report emphasises that **invoking a guarantee could impose considerable fiscal strain** on the state government.
    - To mitigate potential stress, the Group proposes **imposing a ceiling on guarantees,** limiting them **to 5% of** Revenue Receipts **or 0.5% of** Gross State Domestic Product (GSDP)**,** whichever is lower.
- **Disclosures & Honouring Commitments:**
  - The Group recommends that the RBI should suggest **banks/NBFCs to disclose the credit given to State-owned entities with State-government guarantees.**

- The report emphasises the **need for a comprehensive database to track extended guarantees**, proposing the creation of a unit at the State level for this purpose.
- Acknowledging potential risks, the report highlights that **delays in honoring guarantees could harm the State government's reputation** and pose legal risks.
- It advises **States to be cautious when providing finance to entities** with a history of not meeting commitments.
- Additionally, the report emphasizes the **importance of promptly honoring guarantees to maintain credibility** with lenders and investors.

What are the Different Guarantees Given by the Government?

- **Guarantees given to RBIs**, other banks and Financial Institutions (like **IFCI, LIC, UTI** etc) **for repayment of principal and payment of interest,** cash credit facility, financing seasonal agricultural operations, and for providing working capital in respect of companies, corporations, cooperative societies and cooperative banks.
- Guarantees given in pursuance of agreements entered into by the **Government of India with International Financial Institutions** towards repayment of principal, payment of interest etc.
- **Counter-Guarantees to Banks in consideration of the Banks having issued Letters of Authority to Foreign Suppliers** for Supplies/Services made/rendered by them on credit basis, in favour of the Companies/Corporations.
- **Guarantees given to Railways**/State Electricity Boards for due and punctual payment of dues/freight charges by Companies/Corporations. **(Nil for past few years)**
- **Performance guarantees given for fulfilment of contracts/projects** awarded to Indian companies or Foreign companies in foreign countries. (Nil for past few years)

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