GOVERNMENT GUARANTEE POLICY FOR TONGA

1. GENERAL PROVISIONS

1.1 PURPOSE

This policy outlines the Government of Tonga's approach to guaranteeing the debts of private companies and state-owned enterprises (SOEs), supporting development goals while managing associated fiscal risks. Government guarantees policy aims to promote investment and reduce lender risk but also ensures that these guarantees 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 guarantee from the Government.

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

"Contingent Liability" means a possible obligation that arises from past events whom existence will only be confirmed by the occurrence or non-occurrence of one or more unforeseen events not wholly within the control of an entity.

"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.

"Guarantee" means the commitment of the Government to repay if the Borrower default.

"Guarantee Beneficiary" means the party that is assured of payment by the Government of Tonga if the principal obligor fails to meet their obligations.

"Guarantee call" means the occurrence of a trigger event defined in the guarantee agreement which gives the Guarantee Beneficiary the right to request payments from the Government of Tonga.

"Guaranteed entity" means a borrower, whose debt is guaranteed by the Government of Tonga.

"Government" means the Government of Tonga.

"Indemnity" means an obligation of the Government of Tonga to compensate the Lender should the Borrower defaults on a government guaranteed loan.

"Letter of Consent" means a formal document issued by the Government of Tonga conveying its agreement to provide guarantee to a loan. This also entails the formal document issued by the Borrower to the Lender conveying its agreement to grant access to the Government of Tonga to the status of the guaranteed loan.

"Lender" means the financial institution that provides loan to the Borrower that is to be guaranteed by the Government.

"PDMC" refers to the Public Debt Management Committee.

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

1.3 OBJECTIVES

1.3.1 The main objective of this Government Guarantee Policy is to establish a clear framework toward the application of the Government's guarantees to support Tonga's development priorities while ensuring that the risks associated with these guarantees are managed effectively 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 Sections [31 & 34] of the **Public Finance Management (PFM) Act 2002** and relevant regulations governing the issuance of sovereign guarantees.

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

c) **Ensure the prudent evaluation, monitoring, and management** of the costs and risks associated with the provision of guarantees, in line with fiscal responsibility.

d) **Uphold the principles of transparency and accountability** in government decision-making related to the issuance of sovereign guarantees, in accordance with applicable legal and regulatory standards.

e) **Promote the efficient and effective use** and management of public resources, ensuring that the issuance of guarantees contributes to development objectives without jeopardizing fiscal stability.

1.4 SCOPE

1.4.1 This Policy applies to all guarantee requests for Government guarantee on loans or any other forms of borrowing, indemnities and letters of consent/comfort, as well as oversight of these instruments once approved.

1.4.2 The scope of this framework provides guidance for prospective loan guarantee beneficiaries, guaranteed entities, and the Ministry,

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

1.5 ADMINISTRATION AND REVIEW

1.5.1 The Government Guarantee 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 guaranteed entities with respect to their guaranteed facilities.

1.5.3 The Ministry (FFD) shall be responsible for the administering of the government guarantees 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 guarantees 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.

c) Budget Statement.

2.2 CRITERIA

2.2.1 The Government shall issue a guarantee only if all the following criteria are met:

a) The guarantee is permitted by the PFM Act, the Budget Appropriation Act, and other relevant legislation.

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

c) The guarantee 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 guarantee to any entity shall be based on the satisfactory performance of previous guarantee and the outcome of the credit risk assessment.

e) The proposed guarantee 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 deny, based on the project's ability to generate positive financial and economic benefits to the country.

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

I. The policy objectives cannot be achieved without the guarantee.

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

III. The guarantee 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 guarantees 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) Guaranteed Entity (Borrower)
g) Guarantee Beneficiary (Lender)

2.4 GUARANTEE AGREEMENT

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

3. RISK MITIGATION MEASURES

3.1 LIMITS

3.1.1 In line with PFM Act section 25 and 31(1), the government sets the limit in the annual budget statement. These limits include:

a) Amount of outstanding guarantee in any given financial year does not exceed five (5) percent of domestic revenue.

3.1.2 The granting of guarantees is also subject to the limit imposed by the PFM Act, unless there are special circumstances that make it expedient to exceed the limit, in which case the Minister of Finance may seek the Cabinet's approval to do so.

3.2 PARTIAL GUARANTEE AND DEDUCTIBLES

3.2.1 The PDMC may recommend partial guarantees, offer guarantees which exclude any penalties caused by the guaranteed entity or deductible amounts to reduce government exposure based on risk assessment.

3.3 CONDITIONS

3.3.1 Guaranteed entities shall use the loan proceeds solely for the purpose stated in the application for the guarantee.

3.3.2 Guaranteed entities and guarantee beneficiaries must provide the Ministry with periodic reports and audited financial statements on an agreed schedule with the Ministry (monthly/quarterly/annually) or as specified on the guarantee agreement. Additionally, the guaranteed entities 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 the guarantee being called.

3.3.3 The validity of the guarantee shall be restricted to the guarantee beneficiary and will cease to be in full force and effect if the beneficiary's ownership changes unless there is a prior written consent from the Ministry.

3.3.4 The request for government guarantees 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 guarantee request and must provide written confirmation from relevant authorities to this effect. Any arrears or outstanding liabilities must be settled before a guarantee request will be considered.

3.3.5 The Government reserves the right to revoke, suspend or terminate a guarantee for non-compliance with the conditions set forth in section 3.3.1 to 3.3.4 above as well as non-payment of any guarantee fees due.

3.3.6 The government can also include any additional conditions necessary and appropriate to (i) reduce the risk of the guarantee being called; (ii) allow the government to recover any amounts it pays under the guarantee; (iii) mitigate the impact of any unforeseen financial distress.

3.4 FEES

3.4.1 The government shall charge the borrowers who receive a government guarantee 1 per cent of the outstanding value of the borrowing at the beginning of each year.

3.5 COLLATERAL

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

4. PROCEDURES AND GUIDELINES

4.1 APPLICATION PROCEDURES

4.1.1 All guarantee requests must be submitted to the CEO of the Ministry of Finance by the guaranteed entity. For SOEs, guarantee requests shall be conveyed to the Ministry through the Ministry of Public Enterprise.

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

4.1.3 The Financial Framework Division (FFD) shall conduct necessary assessment of the request before presenting to the Minister for final approval.

4.2 DOCUMENTATION REQUIREMENTS

4.2.1 The government shall only consider a request for a guarantee upon receiving the following documentations:

a) Details of the borrowing that would be guaranteed, 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 guarantee. 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 and lender's strategies for minimizing the risk of a call on the guarantee.

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

4.3 EVALUATION AND ASSESSMENT

4.3.1 The Ministry shall evaluate guarantee 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 guarantee 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 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 the guarantee is necessary and cost-effective.

4.3.4 The PDMC's recommendation shall then be submitted to the Minister for approval.

4.4 DECISION MAKING AND NOTIFICATION

4.4.1 The PDMC shall prepare a report summarizing their assessment and the results of the credit risk analysis, along with a recommendation on whether the application for a guarantee 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 deny the request.

c) The Minister's decision will be communicated, through the CEO, to the Deputy CEO of FFD and the PDMC.

d) The Deputy CEO of FFD will prepare a Guarantee and Cabinet paper, which will be submitted by the CEO for Cabinet approval.

e) Following Cabinet approval or rejection, the CEO will:

i. Request the Attorney General to prepare a legal opinion.

ii. Provide feedback to the requesting entity, and in the case of SOEs with a copy to the Ministry of Public Enterprises.

f) The Minister will inform the Legislative Assembly of the decision after Cabinet approval or rejection.

g) 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 recording of all data pertaining to the Government Guarantees 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 guaranteed entities and guarantee beneficiaries shall be responsible for the monitoring the risk status of the guarantees, disbursements, payments due, actuals, timely collection of guarantee fees, and the 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 guaranteed entities.

5.3 REPORTING AND DISCLOSURE

5.3.1 FFD shall be responsible to ensure accurate and timely reporting. Lenders must comply with periodic and ad-hoc reporting requirements in 3.3.2.

5.3.2 Statements on government guarantees 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 guarantees.

6. CALLED GUARANTEES

6.1.1 If a guaranteed entity detects a possible default situation, it should do the following:

a) Inform the Ministry (and the Ministry of Public Enterprises, in the case of SOEs) as soon as possible.

b) Use its best efforts to negotiate with the guarantee beneficiary for deferment of payments or forbearance.

c) Give notice to the Ministry as stipulated in the agreements between the parties.

6.1.2 Upon giving notice and expiry of the agreed grace period, the Guarantee Beneficiary has the right to call upon the guarantee.

6.1.3 The Ministry will assume the obligation and make good of all or part of the amounts due as stipulated in the Guarantee.

6.1.4 Depending on the agreement, the Ministry of Justice might be required to provide a legal opinion before the Ministry assumes the obligation.

6.1.5 If an SOE defaults on a guaranteed loan, the Ministry shall extend a subsidiary loan the SOE if the SOE is experiencing liquidity issues but remains solvent. If the SOE is in distress and expected to remain in such condition, the Ministry shall recapitalize the entity. PDMC will analyse the situation and provide advice to the CEO for Finance.

6.1.6 If a Guaranteed Entity that is not an SOE defaults on a guaranteed loan, the Ministry will endeavour to settle the obligation as committed. However, Government will take legal action to recover the funds

6.1.7 The lender shall be responsible for monitoring loan repayments and securing assets before calling on the government's guarantee. The Government shall only fulfil its obligations after all secured assets are realized.

7. CREDIT RISK ASSESSMENT METHODOLOGY

7.1 METHODOLOGY

7.1.1 Credit risk assessment will be employed to evaluate the creditworthiness of prospective guaranteed entities in terms of the likelihood of them repaying the loan. To this end, credit risk assessments methodology 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 determined by the methodology. In addition, a Scenario analysis shall be conducted to evaluate different risk outcomes, ensuring benefits outweigh risks before proceeding with the guarantee.

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 guarantee policy.
- **Roles**:

  (1) Review and approve guarantee requests based on the recommendations and assessments from requested parties.

  (2) Administer government guarantees, ensuring compliance with fiscal and legal requirements.

  (3) Ensure proper record-keeping and monitoring of all guarantees issued.

  (4) Conduct risk assessments, including credit risk evaluations, of borrowers seeking government guarantees.

  (5) Provide guidance on the risk limits for guarantees as per the PFM Act and ensure limits are adhered to.

  (6) Review and report on the performance of guaranteed entities, ensuring that outstanding guarantees do not exceed prescribed limits.

Public Debt Management Committee (PDMC)

- **Responsibility**: The PDMC plays a key role in advising on debt management and assessing the creditworthiness of borrowers.
- **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 guarantees on the public debt portfolio.

  (2) Recommend whether to approve or deny a guarantee request based on financial and economic factors.

Cabinet

- **Responsibility**: Cabinet is responsible for providing the final approval for government guarantees based on recommendations from the Ministry and the Public Debt Management Committee (PDMC).
- **Roles**:

  (1) Review and approve guarantee proposals submitted by the Ministry.

  (2) Consider the broader economic and fiscal implications of approving or rejecting government guarantees.

Ministry of Public Enterprises (MPE)

- **Responsibility**: The Ministry of Public Enterprises (MPE) oversees state-owned enterprises (SOEs) and ensures their compliance with guarantee conditions.
- **Roles**:

  (1) Convey to the Ministry the guarantee requests of SOEs.

  (2) Ensure that SOEs seeking government guarantees meet the necessary operational and financial criteria.

  (3) Collaborate with the Ministry in providing regular reports on the performance of SOEs with government guarantees.

  (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 all government guarantees comply with legal standards and are enforceable.
- **Roles**:
  (1) Review and provide legal opinions on the Guarantee Agreement to ensure its legality and compliance with the law.
  (2) Advise the Ministry on legal risks associated with the issuance of guarantees.
  (3) Assist in legal actions, if required, for the recovery of funds in the event of a default by a guaranteed entity.

Guaranteed Entity (Borrower)

- **Responsibility**: The guaranteed entity is responsible for submitting a formal request for a government guarantee, providing all necessary documentation (e.g., financial statements, project details, and business case), and adhering to the terms and conditions of the guarantee 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 guarantee request.
  (3) Notify the Ministry and the guarantee beneficiary in case of any financial distress or potential default situations.

Guarantee Beneficiary (Lender)

- **Responsibility**: The Guarantee Beneficiary is the entity or party that benefits from the government guarantee and is entitled to call on the government in the event of a borrower defaulting on the guaranteed loan.
- **Roles**:
  (1) Ensure the loan meets the requirements stipulated in the guarantee agreement, including adequate documentation and terms.

  (2) Monitor the repayment schedule and the borrower's financial health throughout the loan's term.

  (3) Notify the Ministry and the borrower of any potential default or financial distress situation that could trigger a government guarantee.

  (4) Collaborate with the borrower and Ministry to resolve any issues and mitigate risks associated with the guarantee.

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