RBI’s guidelines on State ‘guarantees’ on borrowings | Explained

The RBI Working Group examining issues relating to guarantees given by State governments has put forth certain recommendations to “facilitate better fiscal management by the State Governments”.

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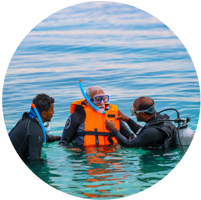
The story so far: On January 16, a working group constituted by the Reserve Bank of India (RBI) made certain recommendations to address issues relating to guarantees extended by State governments. The working group, constituted in July 2022, comprised

of members from the Ministry of Finance, Comptroller and Auditor General of India, and some State governments. Among other things, the Working Group prescribed a uniform reporting framework for the guarantees extended (by State governments) and a uniform guarantee ceiling, besides expanding the definition of what constitutes a 'guarantee.' As per the apex banking regulator, the implementation is "expected to facilitate better fiscal management by State governments."



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What constitutes a 'guarantee'?

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. Per the Indian Contracts Act (1872), it is a contract to "perform the promise, or discharge the liability, of a third person in case of his default." The contract involves three parties: the principal debtor, creditor, and surety. The entity to whom the guarantee is given is the 'creditor', the defaulting entity on whose behalf the guarantee is given is called the 'principal debtor' and the entity giving the guarantee (State governments in this context) is called the 'surety'.

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. This constitutes a guarantee.

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).

What is the purpose of a 'guarantee'?

Primarily, guarantees are resorted to in three scenarios at the State level: first, where a sovereign guarantee is a precondition for concessional loans from bilateral or multilateral agencies (to public sector enterprises); second, to improve viability of projects or activities with the potential to provide significant social and economic benefits; and lastly, to enable public sector enterprises to raise resources at lower interest charges or on more favourable terms.

The RBI working group's report notes that one of the reasons why the instrument has been widely used maybe that an upfront cash payment is usually not required in case of guarantees. While guarantees are innocuous in good times, it may lead to significant fiscal risks and burden the State at other times, it notes. This may eventually result in unanticipated cash outflows and increased debt. Also, the report notes that as the guarantee can be triggered by certain events, the quantum and timing of potential costs/cash outflows are often difficult to estimate.

State governments are often required to sanction, and issue guarantees, on behalf of State-owned enterprises, cooperative institutions, urban local bodies and/or other State-governed entities, to respective lenders. The latter could be commercial banks or other financial institutions. In return, the entities are required to pay a guarantee commission or fee to the governments.

The latest report tabled by the Working Group offers recommendations relating to the definition of 'guarantee', guidelines for according them, ceiling, risk categorisation and honouring guarantees, among other things.

What about the definition of guarantee?

The Working Group has suggested that the term 'guarantee' should be used in a broader sense and include all instruments, by whatever name they may be called, if they create 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 contingent liabilities that may crystallise later— in other words, present a potential risk in the future.

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What about guidelines for according 'guarantees'?

The Working Group has recommended that 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.

It further recommends 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. Furthermore, they 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 they must not be provided to private sector companies and institutions.

Finally, appropriate preconditions, such as period of guarantee, levy of (guarantee) fee to cover risk, government representation on the management board of the borrowing entity, and right to audit, among other things, must be specified.

What about risk determination, fee and ceiling?

The Group, following a prior mandate recommended in 2002, suggested that States assign appropriate risk weights (indicator of the holding the lender should ideally have to adjust the associated risk) before extending guarantees. The categorisation could be high, medium or low risk. These must also consider past record of defaults. They must also disclose the methodology of assigning.

Importantly, the Group suggested States conservatively keep the lowest slab at 100%.

Additionally, it deemed a ceiling on issuance of guarantees as "desirable." The report argues that should a guarantee be required to be invoked, it could lead to significant fiscal stress on the state government. To manage the potential stress, for incremental guarantees (additional guarantees) issued during a year, it proposes a ceiling at 5% of Revenue Receipts or 0.5% of GSDP — whichever is less. And finally, the guarantee fee must be reflective of the riskiness of the borrowers' project and/or activities. Based on the risk assessment, also taking into account the tenure, the base fee or minimum guarantee fee must be set at a minimum of 2.5% per annum. Moreover, additional risk premium may be considered based on the risk assessment.

What about disclosures and honouring commitments?

The Working Group has recommended that the apex banking regulator may consider advising banks/NBFCs to disclose the credit extended to State-owned entities, backed by State-government guarantees. Availability of data, both from issuer and the lender, the report states, may improve the credibility of the data reported by the State government.

It has also sought a proper database capturing all extended guarantees, suggesting that a unit may be set up at the State level to track the same – alongside its compilation and consolidation.

About honouring guaranteed obligations, it recognises that delays may affect the sanctity of issued guarantees, thus, resulting in reputational risk as well as legal risk for the State government. It thus seeks that States must be wary before extending any fresh finance to entities that have failed in honouring commitments before.

"Also, fresh guarantees issued by the State Government may not be readily accepted by the lenders/investors," it observes, adding, "It is, therefore, in the interest of the State Governments to ensure that all guarantees in respect of loans and bonds, when there is a default, are honoured without delay."

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