Performance Audit of the Government's On-lending Activities

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LIST OF ABBREVIATIONS

- ADB – Asian Development Bank
- AfDB – African Development Bank
- BDD – Basic Data and Direction Document
- DeMPA – Debt Management Performance Assessment
- DMFAS – Debt Management and Financial Analysis System
- DPI – Debt Performance Indicator
- EBRD – European Bank for Reconstruction and Development
- EIB – European Investment Bank
- IDA – International Development Association
- IFAD – International Fund for Agricultural Development
- IIPEID - International Investment Projects and Euroatlantic Integration Division
- KFW - The German Development Bank
- MOF – Ministry of Finance of Georgia
- NBG – National Bank of Georgia
- NPL – Non-Preforming Loan
- PDEFD – Public Debt and External Financing Department
- PLA – Primary Loan Agreement
- SAO – State Audit Office of Georgia
- SLA – Secondary Loan Agreement
- SOE – State Owned Enterprise
- UNCTAD – United Nations Conference on Trade and Development
- WB – World Bank

EXECUTIVE SUMMARY

On-lending is a lending instrument utilized by many developing country governments. It occurs when funds are borrowed by a government with the aim of lending these funds to public/private sector entities to support the implementation of different kinds of investment projects. By on-lending a government increases the volume of domestic financial assets. The rationale of on-lending is to support the implementation of the important investment projects without increasing the state budget burden by servicing the external debt. During the last 5 year on-lending portfolio of the Government of Georgia has been on an increasing trend and as of 2014 it amounted to 1.2 billion Georgian Lari (GEL), 15.5% of external debt.

Significant amount of the on-lending portfolio, increased number of reorganized loans in the portfolio and negative assessment of the on-lending component by the World Bank encouraged the State Audit Office of Georgia to audit the on-lending activities of the Government. In the framework of the audit the following topics were assessed: the selection process of the final beneficiary of externally borrowed funds, risk assessment practice corresponding to on-lending, loan monitoring and recovery, accounting and reporting the on-lending activities. The audit has revealed a number of deficiencies in the on-lending activities of the Government:

- ❖ Ministry of Finance of Georgia (MOF) does not have in place a comprehensive on-lending policy document setting the criteria for debtor selection and responsibilities of the entities involved in the process. Mainly the selection of the debtor is done by the donor organization and the MOF does not check the financial soundness of the company assumed to be a final beneficiary of the externally borrowed funds. As a result, debtor selection process does not include the due diligence activities and at the moment loans are extended to the companies in financial difficulties;
- ❖ The risks related to the lending activity are not assessed, priced and taken into account in determining the terms and conditions of on-lending. The MOF did not undertake any independent credit risk assessment prior to the on-lending transactions. In addition, the MOF does not have in place a written guideline describing how credit risk should be assessed and the way corresponding loan terms should be formulated when evaluating on-lending proposals. As a result, the basis of extending (or reorganizing) the loan to the entity whose financial situation does not guarantee the loan repayment is ambiguous.
- ❖ Monitoring the performance of the lending and on-lending agreements is one of the important operations for the effective portfolio management and one of the statutory requirements. Monitoring function of the MOF is not an effective tool in detecting the threats in terms of loan recovery. An existing credit monitoring system does not provide the MOF with the sufficient information about the financial soundness of the borrower and does not ensure the identification of the potential problems in debt servicing;
- ❖ The existing practice of recording the on-lent loans does not ensure the completeness, and provided information does not reflect the real standing of the on-lending portfolio. In addition, detailed information about the current standing of portfolio is not disclosed publicly neither by means of web sources nor it is included in the budget documents. Therefore, the transparency of the data is not ensured.

Considering all the shortcomings prevailing in the management of the on-lending activities and to improve the existing on-lending practice, the State Audit Office of Georgia elaborated corresponding recommendations.

PILOT PERFORMANCE AUDIT OF THE GOVERNMENT'S ON-LENDING ACTIVITIES

1. Introduction

Investments in modern infra¬structure, like building roads, bridges, power transmission lines, and water supply and sanitation systems, lay the foundations for economic growth. Infrastructure investments may accelerate economic development in less developed countries and emerging markets. Nations that invest in infra¬structure are better positioned to attract direct foreign investment, stimulate commerce and support local businesses. According to the African Development Bank (AfDB), citizens of countries with prudent financial and investment management are more likely to enjoy better health care, sanitation and other markings of well-being. Since infrastructure projects are expensive, governments often seek co-financing through public-pri¬vate partnerships and multilateral institutions.

Governments around the world support a wide range of activities through credit markets. The goal of Government lending is to provide financial support to enterprises and/or activities at more favorable terms than they would be able to obtain by borrowing on their own. Countries, especially those with lower level of economic development, extensively use the on-lending mechanism in order to support the implementation of the investment projects. Under the prudent implementation of the on-lending practices countries get the opportunity to increase the potential of economic growth.

1.1. Audit Motivation

The State Audit Office of Georgia (SAO) has the legal mandate to examine the issuance of public loans.[1] In addition, since 2012 SAO has been authorized to conduct performance audits complying with the international standards. Till now, SAO had not conducted audits studying the Government's on-lending activities. Moreover, in 2013 World Bank's Debt Management Performance Assessment (DeMPA) analyzed Georgian public debt, as well as, on-lending activities. The indicator DPI – 10 (2) – "On-lending: Availability and Quality of Documented Policies and Procedures" was assessed with the lowest score – D.

At the end of 2014, externally borrowed funds that were on-lent to other public and private entities amounted to 1,210.91 mln GEL, which corresponds to the 15.5% of the total external public debt of Georgia. At the same time, in the on-lending portfolio 9 loans (20% of all loans) were reorganized due to the difficulties in debt repayment, and 7 loans were classified as non-performing loans that in fact, are subject to write-off.

1.2. Audit Objective and Questions

The overall objective of the audit is to evaluate the Government's on-lending activities in terms of institutional arrangements. To this extent audit team incorporated and tried to answer the following audit questions:

[1] Law of Georgia on the State Audit Office of Georgia, article 17.

1. Does the Government undergo the due diligence activities when selecting the debtor?
2. How does the government set the terms and conditions for on-lent loans?
3. How does the Government monitor and recover the on-lent funds?
4. Does the reporting framework ensure transparency and accountability?

1.3. Audit Scope

The audit scope covers the Government on-lending activities and the management of on-lent loans portfolio in the period of 2010-2015. The auditee is the Ministry of Finance of Georgia (MOF).

1.4. Audit Approach and Methodology

The Audit is based on problem-oriented approach. For the data collection reviewing the existing documents, related to on-lending activities and interviewing the officials of the MOF, has been used as the main tools. The Audit team also conducted meetings with the representatives of the donor organizations[2], which support various investment projects in Georgia. Besides, the audit team searched for and chose the relevant international best practices. In case of detailed testing, risk-based approach was used in the selection process.

1.5. Audit Criteria

- ❖ Principles on Promoting Responsible Sovereign Lending and Borrowing, UNCTAD;
- ❖ Guide to the Debt Management Performance Assessment (DEMPA) Tool, the World Bank;
- ❖ Code of Good Practices on Fiscal Transparency, International Monetary Fund;
- ❖ Government Finance Statistics Manual, International Monetary Fund;
- ❖ Local laws and regulations;
- ❖ International best practices;

1.6. Background Information

Main purpose of the Government lending is to provide the project implementation entities with the required funds to successfully implement the corresponding project. Government lending activities are embraced by the sub-national lending. Government of Georgia extends loans from the State Budget sources and/or on-lends externally borrowed funds. Altogether, loans extended from the State Budget and on-lending comprise the state loan portfolio.

In Georgia, Government lending activities are implemented within the legal framework defined by the State Debt Law of Georgia, Budget Code, Annual State Budget Law, General Charter of Ministry of Finance and the Law of Restructuring of Tax Repayments and Government Loans. In addition, mostly main on-lending terms

[2] Asian Development Bank (ADB), European Bank for Reconstruction and Development (EBRD), Kreditanstalt für Wiederaufbau (KfW)

and conditions are set out in the Primary Loan Agreement (PLA) signed between the Government of Georgia and donor organization.

The overall policies and procedures for on-lending operations are set out in the State Debt Law of Georgia. The law provides the MOF with the authority to on-lend the financial resources and keep records of them. Although there is no specific guideline that restricts sources of on-lent funds, in practice, on-lending is made exclusively from earmarked external funding. At the first stage the loan proposal, together with the project description, is sent to the MOF. The MOF, with the Government's[3] consent and in concurrence with the NBG, seeks for the financing from external donors. After the loan agreement with the donor is signed, Government may channel the borrowed funds to the project implementation entity with the terms and conditions stipulated in the Primary Loan Agreement. Mostly, the Government on-lends funds with the same terms and conditions as it borrows from the donor organization; However, there are also loans for which the Government charges higher interest rate than it pays on its liability. To summarize the process, for financing the investment project the Government increases its external liabilities by borrowing from external creditors and transforms those liabilities into financial assets through on-lending operations. In this process, the MOF plays an intermediary role by channeling the external sources to local entities through on-lending agreement. The default on on-lent loan does not exempt the Government of Georgia from obligations towards external creditor

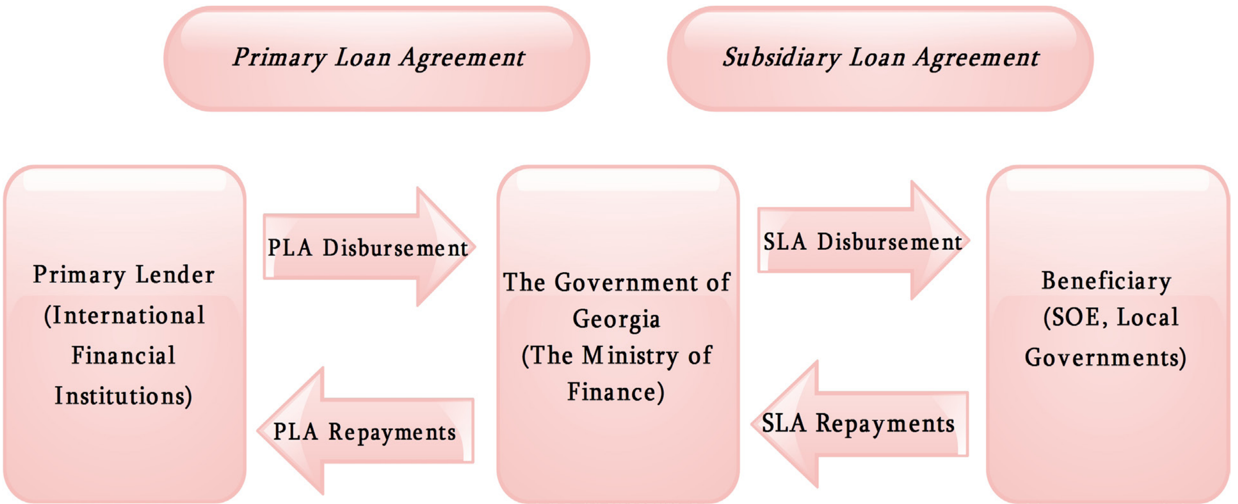

Figure 1: On-lending process

[3] BEFORE THE AMENDMENT IN THE CONSTITUTION OF GEORGIA (OCTOBER, 2013) PRESIDENT'S CONSENT WAS REQUIRED.

Within the MOF the Public Debt and External Financing Department (PDEFD) represented by the Public Debt Division (PDD) and International Investment Projects and Euroatlantic Integration Division (IIPEID), is responsible to participate in the negotiations, draft the on-lending agreement, on-lend the financial sources and monitor the loans throughout the loan life cycle. PDD is in charge of the recording process, in particular, PDD is responsible to record the information about the on-lent loans in the debt management information system – DMFAS and the State Loan Division under the State Treasury Service is responsible to record the information in the State Loan Registry.

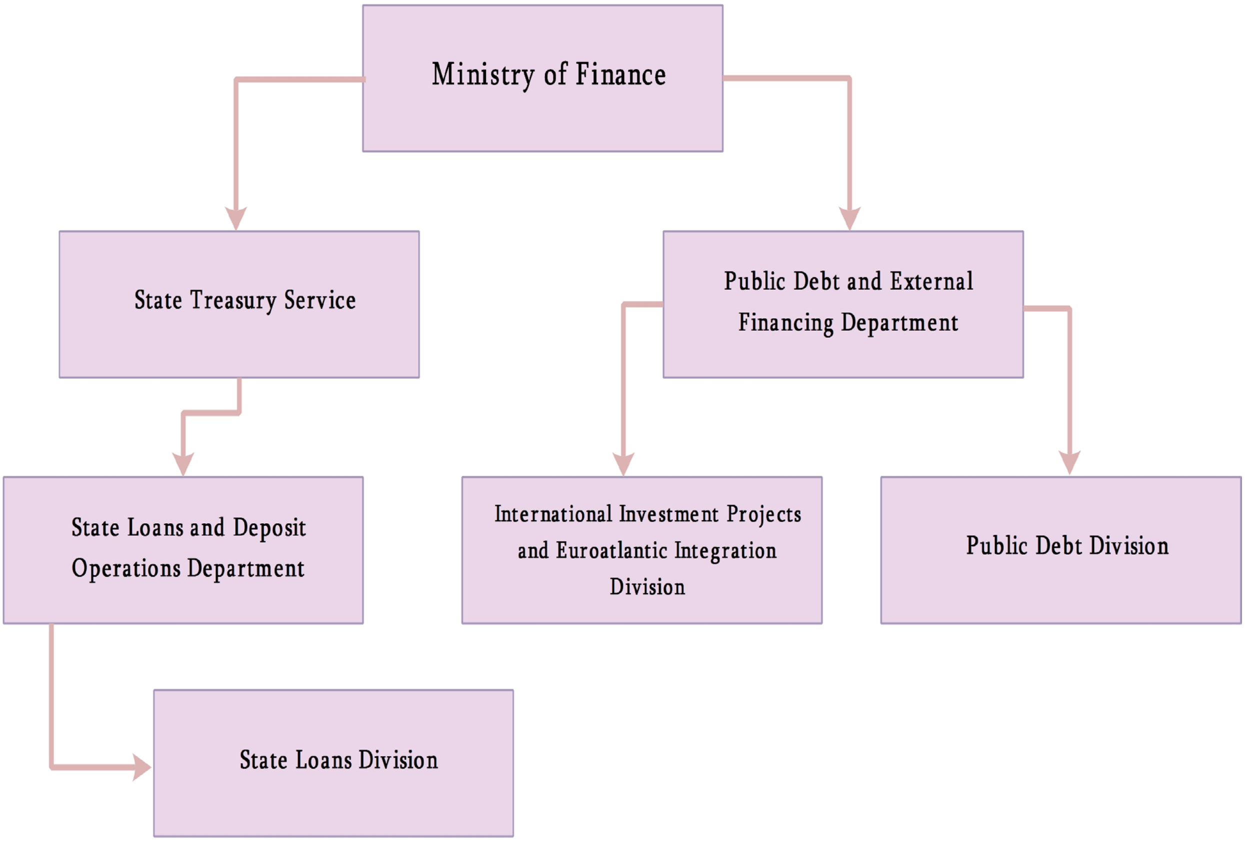

Figure 2: Agencies within the MOF participating in the on-lending activities.

MOF is the only authority to manage the on-lent funds. The State Debt Law of Georgia sets the rules and procedures how to allocate the borrowed funds for investment projects and/or import financing. It is stated that financing the import and/or investment project can be carried out through the financial intermediaries or directly through the MOF. In practice, on-lending operations are carried out directly by the MOF. In order to obtain the loan, economic agents should submit to the MOF investment projects, including the business plan and statement regarding the financial-economic situation of the agent.[4] The MOF should study the presented documents to evaluate the economic agent's ability to repay the borrowed funds and afterwards, makes the decision to on-lend resources. The terms and conditions of the on-lending, in the most cases are predefined and set out in the Primary Loan Agreement (PLA) signed between the MOF and the donor organization.

[4] TATE DEBT LAW OF GEORGIA, ARTICLE 31.

On-lending may also be done through the use of financial institutions. In that case, Subsidiary Loan Agreement is signed with the financial institutions that take the responsibility to invest those funds in a field that is a subject of the the investment project. The difference from the previous option of on-lending is that financial institutions choose the final beneficiaries of the funds and not the MOF .

Therefore, all the documentations regarding the business plan and financial statements of the final borrower are submitted to the financial institution.

During the last five years the outstanding amount of the on-lent loans has been increasing. As of 2014, outstanding loan amount increased by 122%, compared to 2010 level. Taking into account that increasing trend in the on-lending portfolio, it is essential that the Government has been able to manage the corresponding risks. Main risk related with the lending activities is the credit risk that reflects the potential that a borrower or counterparty will fail to meet its obligations in accordance with the agreed terms. If the borrower fails to make required payments, it will have negative effects on the mobilization of the state budget funds that are planned in the budget under the extended loans.

Except credit risk, on-lender can face foreign exchange mismatch risk if it takes foreign currency denominated debt from the international financial markets through a primary loan agreement, but on-lends in domestic currency. In Georgia's case, foreign exchange risk is entirely transferred to the final borrower – state-owned enterprises, because all the on-lent funds are denominated in the same currency as it was in primary loan agreement. In this case, the sound financial and management structure of the borrower companies are crucial to avoid the risk exposure.

In Georgia, on-lending operations are used much more frequently than extending the loans from the State Budget funds. As of December 2014, portfolio of on-lent loans consists of 51 loans, of which 7 are non-performing loans (NPL). The total amount of the portfolio is 1,210.91 mln GEL, from which the overdue loans amount to 37.04 mln GEL (NPL rate 3.1%). 9 bilateral and multilateral donors including most important development financing institutions as ADB, WB, EBRD, KFW, EIB have extended credits to the Government of Georgia that were on-lent to local economic agents. On-lent loans consist of 15.5% of the total external debt portfolio. Under the Subsidiary Loan Agreement (SLA) SOEs (86% of portfolio amount) and local governments (13% of portfolio amount) are mainly represented as borrowers. Only a small portion (0.8%) of outstanding loans is extended to the private companies.

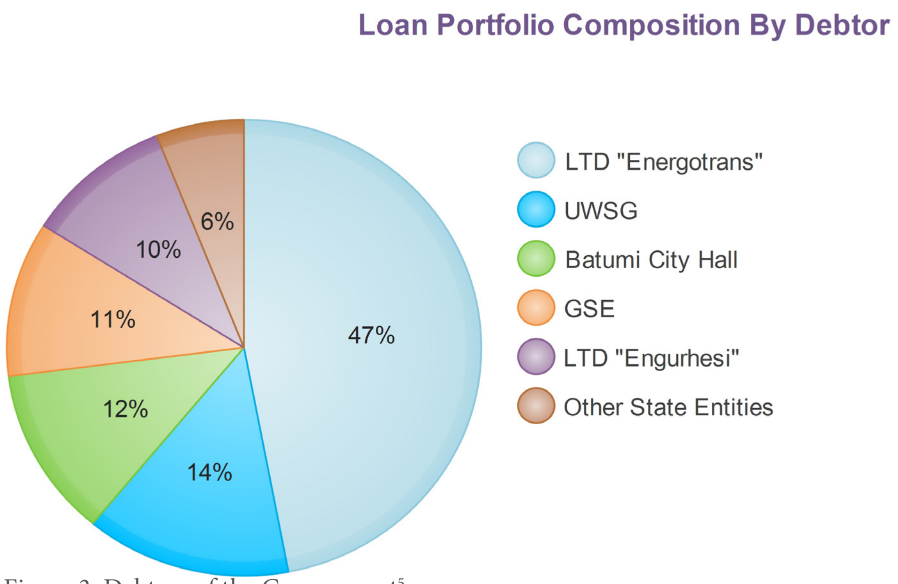

Figure 3: Debtors of the Government[5].

The allocation of the funds depends on the importance of the project. Priority sectors are specified in the Georgia's Basic Data and Direction (BDD) document. Based on the analysis of the current loan portfolio majority of on-lent loans are invested in the energy sector (65%). Also, significant portion (33%) of the total portfolio is invested in the water infrastructure improvement projects. All sectors financed by the externally borrowed funds are set as priorities in recent years' BDD.

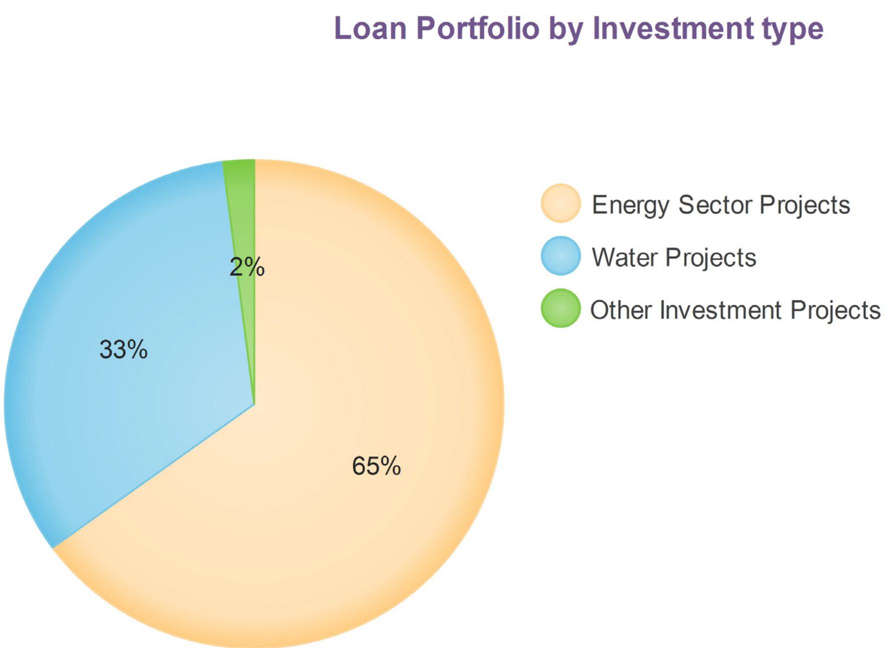

Figure 4: Sectors financed through on-lending operations.

[5] The statistics only includes the outstanding amount of active loans, excluding the NPLs.

2. Selection of the debtor

The effective debt management may be strengthened if it is supported by the policy document setting the conditions for on-lending. According to the "Guide to the Debt Management Performance Assessment" (DeMPA) Tool, elaborated by the World Bank, documented policies and procedures document should be in place, to ensure the comprehensive management of on-lending activities. An effective on-lending policy requires a thorough assessment of projects and programs for which funds are requested, and the rejection of all the programs that are judged to be non-viable. The MOF, in collaboration with the supervising ministry (agency), should review the corresponding documents to evaluate the prospect of the project, especially the possibility to generate adequate income to repay the loan. Financing projects or programmes that would generate income in excess of the borrowing costs to the Government would reduce the budget burden in servicing that debt. In addition, before a decision is made, the Government should consider other alternative financing forms (state guarantee, grants) by comparing the costs and risks of different financing options.

According to the State Debt Law, on-lending activities might be carried out directly by the MOF or by the use of financial intermediaries. It should also be mentioned that the law does not clearly state in which conditions one option of on-lending is preferred over another. However, based on the respective financial document of the beneficiary, in both ways of financing, it should be analyzed and checked whether the borrower is creditworthy. . Based on State Debt Law, this is one of the main requirements to extend or not the loan.

According to the UNCTAD principle 12, the fact that donor organizations conduct a thorough ex-ante investigation of a project, to be executed by public sector entities, does not relieve the Government of its independent responsibilities in this regard. According to the international best practice the risks should be assessed, priced and taken into account in determining the mark-up fee and the terms of on-lending. This requires the adoption of an explicit and transparent policy for the management of on-lending activities.[6] Taking into consideration the increased stock of on-lending funds, government should pay significant attention to the risks exposed in the on-lending activities. Main risk accompanied to the subsidiary loan is credit risk, which relates to the potential inability of the beneficiary to meet its debt service obligations. Thus, if the company defaults on a subsidiary loan, its payment obligations become the burden of the state budget. In order to mitigate the credit risk, on-lender should carefully analyze borrower's financial position, as well as proposed project's usefulness, feasibility and profitability before making the decision to lend money.

The State Debt Law of Georgia is the only document where overall rules and procedures for on-lending operations are set out, but it still does not provide the complete picture of the whole process. In practice, debtor selection process is carried out by the donor organization itself. In particular, during the feasibility study stage donor organization identifies the final beneficiary of the funds. As a result in the debtor selection process the role of the MOF is minimal. Here, one important issue should be taken into account, in particular, the characterization of projects might be a main determinant when on-lending directly. For instance, as can be seen from the portfolio, by on-lending the Government mainly finances big projects in energy sector and water infrastructure. In these sectors there is no option to choose the final beneficiary of the loan, while only state-owned enterprises are operating in this field. Therefore, when the MOF receives a project proposal to be financed from the external sources, final beneficiary is already defined. However, representatives of the MOF do not check the financial situation of the proposed company to be a beneficiary of the funds.

[6] UN, (2006): "Manual on effective debt management", United Nations Publication, p. 6.

As a result, debtor selection process does not include the due diligence activities and at the moment loans are extended to the companies that are under the rehabilitation or are the successors of the several small SOEs that were facing severe financial problems including the repayment of debt to the MOF. In 2013-2014, the MOF signed three SLAs with the a state-owned company - Georgian State Electrosystem (GSE) that due to the financial problems is under rehabilitation program till 2023. In the framework of these loan agreements GSE received 60.21 mln EUR, 60.0 USD and 29.69 mln SDR for the implementation of projects in the energy sector. On-lending has been done without checking the current financial situation of the borrower.

According to the MOF, they do not participate in the debtor selection process mainly for two reasons: i) There is no other company that could implement the project, therefore there is no need to start a selection process; ii) Feasibility study and other assessments, including the financial standing of the debtor is done by the donor organizations and the MOF relies on their (donor organization) studies. These arguments cannot be considered as reasonable because the final beneficiary of the loan is obliged to repay the borrowed funds to the MOF and not to the donor organization. Thus, if the debtor defaults on its liabilities, it would increase the budget burden of servicing the PLA as the budget revenues from loans (on-lending) would decrease.

Regarding the debtor selection process there is a good practice implemented when on-lending through the financial institutions. In general, taking into account that financial institutions (Commercial banks, Micro-Financial Institutions) are more experienced in loan making, they may have an advantage over the MOF or other Governmental agencies to detect the financial viability of the project and financial soundness of the debtor more successfully. Besides, in the on-lending portfolio only one loan is extended using the financial institutions. To support the rural development project the Government attracted financial sources from the International Fund for Agricultural Development (IFAD) and International Development Association (IDA) that with use of participating financial institutions (Commercial banks and Non-bank financial institutions) were on-lent to the final beneficiaries. To this extent, joint order N314 has been issued by the ministers of finance and agriculture approving the operational instructions for project financing. This document, among other important issues, fully covers the debtor selection process, in particular, eligibility requirements, including the experience, financial-economic situation, organizational structure; only those financial institutions that fulfilled all the given eligibility criteria were able to get the funds.

The analysis of the sample of loans issued in the last five years revealed that the MOF did not undertake any independent credit risk assessment prior to the on-lending transactions. In addition, the MOF does not have in place a written guideline describing how credit risk should be assessed and the way corresponding loan terms should be formulated when evaluating on-lending proposals. The only study, which is conducted prior to on-lending funds to the final borrower, is carried out by the donor organizations. They conduct the feasibility studies of the projects, which are financed by grants. In some cases, donors may also review the financial positions of the final borrowers, but it does not influence the decision to lend money to the government, because the government is obliged under the PLA to pay back all the liabilities and it is up to the Government to on-lend or not to on-lend the borrowed funds.

Credit risk management is an essential element to promote the responsible lending. MOF or any Government entities acting as lenders do not conduct the credit risk analysis of the counterparties. Moreover, risk assessment is not conducted when the borrower requests the reorganization of the loan agreement. For instance, in 2014 the MOF rescheduled the loan repayment to the state-owned company – Ltd "Energotrans"[7] several times. The motivation and the basis of the loan reorganization was the letter that the MOF received from the borrower, highlighting the importance of the loan rescheduling due to the decreased revenues of the company. The MOF accepted to reschedule the loan without getting an assurance on the borrower's financial troubles and without checking its ability to service the loan on reorganized terms. The rescheduled amount of loan equaled to 13.7 mln EUR that negatively affected the mobilization of the corresponding financial resources in the state budget.

Credit risk could be managed by the establishment of appropriate credit limits for each institution and through active monitoring of the credit rating or financial position of each institution. Absence of guidelines, procedures and clear instructions for credit risk assessment process, leads to an inefficient use of budgetary funds. At present, portfolio of on-lent loans comprises a significant number of reorganized loans and 7 loans in default standing.

In some cases donors know in advance that there is a high risk that the final borrower will be unable to repay the loan if certain conditions are not met. Consequently, a list of recommendations is followed from the donors to improve the company's financial positions and to transform it to a profit generating entity. However, the Government finds it difficult to implement certain recommendations[8] and makes a decision to on-lend borrowed funds. As a result, the basis of extending (or reorganizing) the loan to the entity whose financial situation does not guarantee the loan repayment is ambiguous.

According to the international practice, documented lending policy, risk assessment methodology and corresponding procedures' manuals that are properly developed and implemented will enable the MOF to:

(i) maintain sound credit granting standards;

(ii) monitor and control credit risk; and

(iii) identify and administer problem credits.[9]

Besides that the existence of the above mentioned documents ensure the development of the institutional memory and increase the transparency of the on-lending activities. Simultaneously, it will facilitate the MOF to manage the on-lending activities more effectively.

Conclusion:

Considering the characterization of the projects financed by on-lending the funds the MOF mainly uses direct on-lending. In spite of statutory requirement the selection process of the final beneficiary does not include the assessment of the company's financial position. As a result, funds are on-lent to the SOEs that are under the rehabilitation, without previous experience or successor of former small SOEs in financial distress. There is no written Government on-lending guideline or procedures manual describing the overall process of on-lending and responsibilities of involved parties on each step.

[7] Decrees of the Government of Georgia N992 06.06.2014 and N2231 10.12.2014

[8] The difficulties arise when the donors recommend amending the tariff setting policy in a field where the project should be carried out.

[9] Central Bank of Malaysia, (2009): Guidelines on Best Practices for the Management of Credit Risk for Development Financial Institutions, p. 14.

Governments on-lend externally borrowed funds to the public sector entities to provide them with concessional loans in order to finance big infrastructure projects. No credit risk assessment is undertaken prior to the on-lending transactions and during the loan reorganization request from the borrower. There are no written procedures describing how credit risk should be assessed in evaluating on-lending proposals. In addition, no credit risk analysis is conducted prior to on-lending the borrowed funds. MOF does not carry out the due diligence of the potential debtors. Actually, economic agents' creditworthiness is assessed only in case of on-lending through financial institutions.

Recommendation:

In order to ensure the on-lending to the financially sound companies, to comply with the statutory requirements, to facilitate the stable and timely repayment of on-lending funds by the economic agents, the State Audit Office of Georgia gives following recommendations to the MOF:

- ❖ To elaborate the on-lending policy document clearly stating the eligibility criteria for the economic agents willing to obtain the funds and function of all involved entities in the on-lending process. Existence of the documented policy and procedures would facilitate the effective management of the on-lent loans.
- ❖ To elaborate the formal guideline/manual on the risk assessment, including the evaluation of project's financial implications and to conduct the credit risk analysis prior to on-lending and whenever the terms of agreed contracts are going to be changed due to the loan reorganization. Based on the assessment results make an informed decision on financing form (Loan, Grant, Guarantee, etc.) and on corresponding terms and conditions of the agreement;

3. Monitoring and recovery of on-lent funds

The principal basis for the decision to on-lend is that the project or program, when completed, would generate adequate revenue to make debt service payments without a government subsidy. The repayment period normally stipulated for on-lending depends on the repayment capacity of the project as determined in the feasibility study. In principle, the repayment period should not exceed that in the agreement between the government and the lender. Debt service payments are made by individual borrowers to the MOF. When payments are not made on time, the on-lending agencies should take the measures necessary to recover the funds from the borrower based on the agreement signed with the borrower and current laws of the country.[10]

The institutions through which government loans are on-lent should take full responsibility for the management of the individual loans that are extended by them. Borrowers should be required to provide periodic reports to the MOF on the implementation of the projects/programs financed. This will provide the basis for the reports to the MOF along with data collected through supervision of the loans by the relevant on-lending agency.

Monitoring the performance of the lending and on-lending agreements is one of the important operations for the effective portfolio management. According to the State Debt Law (Art. 10) borrowers are responsible to provide MOF, quarterly, with the information about the spending of borrowed funds and on the debt repayment situation. In practice, borrowers provide the MOF with the quarterly reports regarding the progress of the projects and the funds spent in the project. In the reports nothing is said about the repayment of the loan and the financial situation of the borrower company regarding the debt repayment. Therefore, the statutory requirement is partially fulfilled. Submitted quarterly reports do not give the MOF information about the financial soundness of the company and therefore, it is difficult to detect any financial difficulties that the borrower has in place or might face in the future.

Monitoring function of the MOF should be an effective tool in detecting the threats in terms of loan recovery. An effective credit monitoring system should include measures to:

(i) ensure that the lender understands the current financial condition of the borrower;

(ii) monitor the usage of approved credit lines by borrowers;

(iii) ensure that the projected cash flow by major credits meet debt servicing requirements; and

(iv) identify and classify potential problem credits on a timely basis.[11]

The existing practice of monitoring the on-lent loans does not meet all the requirements set by the best practices of credit monitoring. The MOF only obtains the information regarding the usage of funds and the progress of the financed project. The financial position of the borrower is not monitored that exposes the lender to the risk that possible threats related to the loan repayment might not be detected and treated on a timely manner.

[10] UNITAR (2002): "Institutional framework for public sector borrowing", Document No. 17, p.27

[11] Central Bank of Malaysia, (2009): Guidelines on Best Practices for the Management of Credit Risk for Development Financial Institutions, p. 28.

Conclusion:

According to the State Debt Law of Georgia the MOF is responsible to monitor the performance of the on-lending agreements. Quarterly reports provided by the borrowers include the information on the progress of the project and funds utilized on it. There is no information provided regarding the repayment of the loans and financial situation of the company. Therefore, existing practice of monitoring does not allow the MOF to detect and treat the possible threats regarding the loan recovery, thus, the statutory requirement is partially fulfilled.

Recommendation

To ensure an effective loan monitoring mechanism, avoid belated responses on the existing problems and comply with the statutory requirements, the State Audit Office of Georgia has given following recommendations to the MOF:

- To request the financial information from the borrowers in quarterly reports, the reports should be analyzed, and if the results point to some repayment troubles which might be realized in the future, report them to the management for further actions.

4. Reporting

Reporting to the Parliament, public, the President and oversight entities is an important and indispensable component of accountability and transparency. Debt management decisions and actions must be based on accurate and updated information on the debt portfolio. The same logic holds when the Government extends loans directly or by on-lending the external funds. According to the "Code of Good Practices on Fiscal Transparency", elaborated by the IMF, the public should be provided with comprehensive information on the fiscal activity and on major fiscal risks. Under this framework the government should publish information on the level and composition of its financial assets.

Within the MOF, the public debt division of the PDEFD is responsible for recording the loans extended from the external funding sources.[12] After the SLA is signed with the loan beneficiary, on-lending terms and conditions are recorded in the DMFAS. In addition, information about the on-lending portfolio is reflected in the State Loan Registry that is prepared by the State Treasury. State Loan Registry is an MS Excel based database where the Annex 2 is dedicated to the loans extended from the externally borrowed funds. The source of the information for this database is the PDEFD that on request sends the data about the on-lending portfolio to the State Treasury Service.

It should be noted that according to the Budget Code of Georgia (Article 59), loans extended from the externally borrowed funds are not subject of recording in the State Loan Registry. However, the order of the Minister of Finance N305 assigns the responsible entity to record all the loans, including the on-lendings, in the above mentioned registry. As a result, in practice, recording of the on-lent loans is done by the two entities in two different databases.

Comparing the data extracted from DMFAS and State Loan Registry regarding the on-lending portfolio revealed several inconsistences:

- In the State Loan Registry it is not possible to detect the outstanding amount of the loans while it lacks the information about the repaid principal and only records the sum of repayments (principal, interest, and penalty) made to the date;
- In the DMFAS database some on-lent loans (two line of credits and 7 problem loans) are missing due to the difficulties arising when recording in the system, although they are all presented in the State Loan Registry;
- Beside the fact that two entities are in charge of loan recording, neither database is complete. In particular, the information of the loan taken from the IFAD[13] and on-lent to different financial institutions could not be found in either registry.

Hence, two databases including the information on on-lent loans are incomplete and do not reflect the real standing of the on-lending portfolio. Moreover, the current information about the portfolio is not published online nor it is reported in the budget documents. According to the MOF, the information about the portfolio is only available when it is requested by the interested parties individually. Therefore, it could be concluded that the transparency of the data is not ensured.

[12] Order N824 of Minister of Finance about the Organizational structure of the MOF issued on 31.10.2008

[13] The funds were borrowed to finance the Agricultural Support Project.

According to the international standards, the unit in charge of making data records must establish a uniform accounting system, as well as the requirements for the reports concerning its content and form.[14] To this extent, after analyzing the portfolio data extracted from the DMFAS, there is no uniform (universal) approach of recording the same transaction on the on-lent loans. For instance, when reorganizing the loans, in some cases the reorganized amount is capitalized in the principal, and in other cases it is recorded as separate loan that does not have a separate repayment schedule nor there is a separate signed agreement.

Debt rescheduling or refinancing represents one of the types of debt reorganization (restructuring). This involves relief for the debtor from the original terms and conditions of debt obligation to address the existing financial problems in loan servicing. As of 2014, the MOF refinanced or rescheduled 9 loans. Based on the GFSM (2001), debt reorganization reduces liabilities by the amount of debt that has been reorganized and increases liabilities by the market value of the new debt.[15] In other words, with debt reorganization, the applicable existing debt is recorded as being repaid and a new debt instrument is recorded for the reorganized part. The mentioned rule of recording the debt reorganizations is not considered by the MOF for all loans in question. Moreover, in the State Debt Registry reorganized parts of the loan are not recorded and in DMFAS recording of debt reorganization is not unified. For example, the MOF reorganized arrears of the loan extended to finance "Energy sector rehabilitation project II". At the moment of reorganization arrears equal 1,207,782.41 GEL (Principal – 751,941.18; Interest – 394,094.44; Penalty – 61,746.79). Reorganized amount of the applicable loan has been recorded as a new debt instrument but at the same time this transaction did not affect the amount of principal paid on the original debt. Consequently, the difference between the disbursed loan amount and paid principal does not equal to the real outstanding debt.

	Disbursed Loan amount	Principal paid	Outstanding amount indicated in DMFAS	Difference	Difference
	(1)	(2)	(3)	(1) - (2)	(4) - (3)
"Energy sector rehabilitation project II"	12,782,297	6,767,471	5,262,885	6,014,826	751,941
"Energy sector rehabilitation project II" reorganized part	1,207,782	139,025	1,068,758	1,068,758	0

Table 1: Extract from on-lending portfolio

The maintenance of an accurate database underpins the analytical work that is performed in debt and risk management tasks and is important not only for the public debt management purposes but also for the on-lending activities. Updated and reliable database of the on-lending portfolio is an essential prerequisite to conduct a high quality analysis generating reliable results. This would facilitate the MOF to make effective decisions regarding the on-lending activities.

[15] IMF, (2001): "Government Finance Statistics Manual", p.162

Conclusion:

The recording of the on-lent loans in the State Loan Registry is incomplete and it is not publicly available. The records extracted from the DMFAS do not coincide with the information given in the State Loan Registry, prepared by the State Treasury. Moreover, on-lending carried out by the Ministry of Agriculture is not registered in either database. The existing practice of recording the on-lent loans does not ensure the completeness, and provided information does not reflect the real standing of the on-lending portfolio. In addition, detailed information about the current standing of portfolio is not disclosed publicly neither by means of web sources nor it is included in the budget documents. Therefore, the transparency of the data is not ensured.

Recommendation:

Responding to the current deficiencies in recording and reporting of the on-lent loans, the State Audit Office of Georgia has given following recommendations to the MOF:

- ❖ Update the database of the on-lending portfolio in a recording system that will most conveniently record all the loans extended from the external financial sources and would be in compliance with the current legal norms;
- ❖ In terms of recording debt reorganizations, follow the international best practice given by the GFSM that will ensure traceability and transparency of debt reorganization transactions.