Chapter 8 Auditing On-lending Activities

This chapter looks at the principal characteristics of an on-lending mechanism and assists SAIs to understand international sound on-lending practices, and relates the topic with possible audit types, criteria, sources of evidence, and sample audit questions and findings.

8.1 On-lending Activities

Governments often support public investment programs, regional business developments and the business needs of state-owned enterprises through direct government lending or on-lending of borrowed funds. Such on-lending instruments are expected to provide an adequate supply of credit for the legitimate business or investment needs of the beneficiary, as defined by the respective government policy. The government is also expected to price that credit reasonably in line with competitively determined market interest rates.[26]

Countries, especially those with lower level of economic development, extensively use the on-lending mechanism to support the implementation of investment projects. On-lending occurs when funds are borrowed by a government or a domestic financial institution (normally a public organisation and acting on behalf of the government) with the aim of lending the funds to public sector entities. The loan proceeds are to be made available, through an on-lending agreement, to a third party in the country of the borrower, usually with the previous agreement of the foreign creditor. Thus, on-lending, as shown in *Figure 10*, entails two distinct agreements:

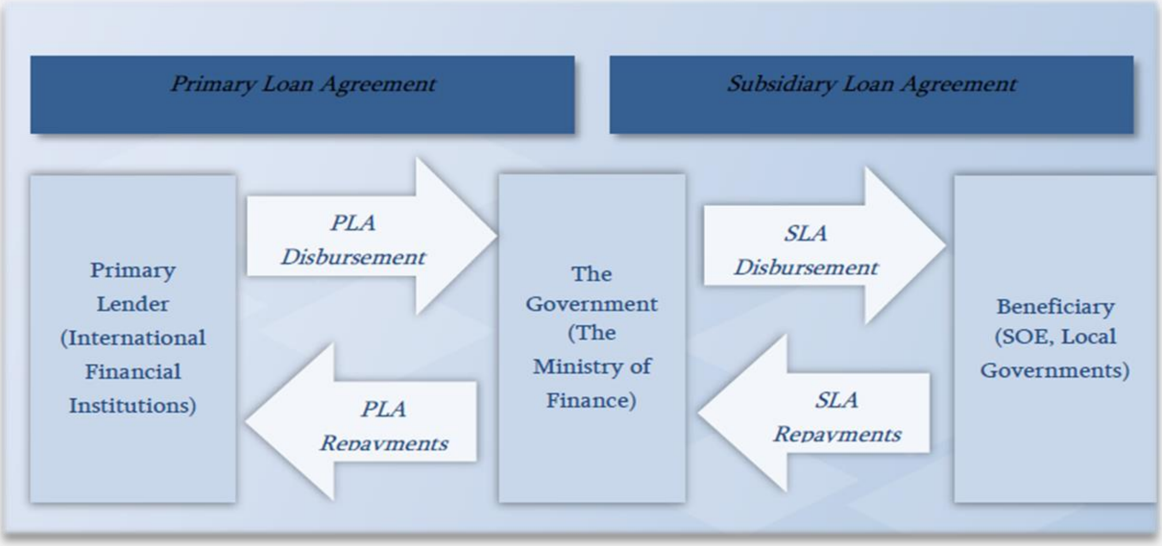
- The direct loan between the creditor (usually the international financial institution) and the government, where the government is the debtor and assumes the debt service under the primary loan agreement (PLA); and

- The on-lent loan between the government and a public sector sub-national institution, where the central government is the creditor and signs a subsidiary loan agreement (SLA) with the final beneficiary.

More complex on-lending agreements may also exist. These may involve more than one public entity as creditor and/or several public sector enterprises as debtors. In effect, the government functions as an intermediary between the borrowing entity (final beneficiary) and the lender. Government on-lending is also often a substitute for guaranteeing loans that are raised directly by the beneficiary.

[26] DeMPA Methodology, http://documents1.worldbank.org/curated/en/305821468190742099/pdf/96671-WP-DEMPA-2015-Box391446B-PUBLIC.pdf

Figure 10. On-lending Operations



The legal basis for on-lending operations is generally set forth under the government's public DeM laws. The government can use multiple channels for on-lending such as the MoF or government agencies established for on-lending in specific sectors. On-lending may also be done through the use of financial institutions (commercial banks or micro-finance organisations). In that case, an SLA is signed with the financial institutions, which take the responsibility to invest those funds in a field that is a subject of the investment project specified in the loan agreement.

When the MoF does not on-lend funds directly to the final borrowers, it establishes the terms and conditions for on-lending agreements with agencies that subsequently channel the on-lent funds. Thereafter, these agencies assume full responsibility for the management of all the individual loans they extend. Individual borrowers make debt service payments to the on- lending agency, which then transfers these funds to the primary lender. In certain cases, the intermediary (sovereign or bank or enterprise) may charge interest on top of the interest of the original loan, which is not transferred to the primary lender.

Very often, the terms of the direct loan and the on-lent agreement will differ; for example, in the amount or repayment terms. The repayment of a loan depends on the terms and conditions in the agreement between the government and the lender. Nevertheless, the repayment period under the SLA usually does not exceed the date stipulated in the direct loan.

Furthermore, whenever a government contracts a foreign loan under market conditions and then makes it available in the form of sub-loans in the domestic or foreign currency, it usually applies the interest rate and fees it owes to the lender plus an annual on-lending fee. It may also charge a preferential interest rate for certain categories of projects; for example, in the social sector or for reconstruction costs following a national disaster.

The IMF's External Debt Statistics: Guide for Compilers and Users provides the following guidance on the debt classification of on- lent loans:

'An institutional unit within an economy might borrow funds from a non-resident and then on-lend the funds to a second institutional unit within the economy. In such instances, the first institutional unit should record an external debt liability, with any subsequent on-lending classified as a domestic asset. If an institutional unit within an economy borrowed from a non-resident and on-lent the funds to a non-resident, the unit should record both external debt and an external claim'.

Receipts from on-lending are reflected in the national budget as sources of financing. Therefore, on-lending will improve the budget position when loans are repaid.

State entities often have the legal authority to borrow on their own terms. However, they are generally not in a strong financial position and therefore are unable to access funds from various lenders at terms that are more favourable than market terms. On-lending provides a means for the state or private entities to benefit from the strength of the government's balance sheet and access to concessional financing. It is also a means for the State and/or private entities to deliver the government's development projects and thereby contribute to an improved economic environment.

The rationale for on-lending is to support the implementation of important investment projects by servicing the external debt without increasing the state's budget burden. By on-lending, the government increases the volume of domestic financial assets.

At the same time, a deteriorating performance of the on-lent loan repayment has a significant adverse impact on the government's fiscal position. Under an on-lending mechanism, the government bears the risk that the borrower entity will default on its loan. Default by the borrower burdens the government with the obligation of debt servicing, which it must finance out of its own resources. Thus, the government is implicitly supporting delinquent borrowers and this is not deemed to be sound governance practice. When this risk is significant, on-lending should be carefully considered against other alternatives, such as open tenders, public–private partnerships or direct private sector development.

DMO authorities must be well prepared to identify, evaluate and mitigate the main sources of risk (currency, interest rate, maturity mismatch risk and credit risk) related to the individual on-lending transactions as well as to the whole on-lending portfolio. The materialisation of such risks would negatively affect cash flows and consequently have an adverse impact on the budget deficit. With prudent implementation of on-lending practices, countries have the opportunity to increase the potential for economic growth.

8.2 Auditing On-lending Activities

Before conducting an audit of on-lending activities, SAIs should have a general understanding of the on-lending operations, agreement types, main institutions involved in on-lending operations, and related rules, regulations and policies. SAIs should perform a preliminary analysis of best practices that govern on-lending operations as a source of audit criteria.

8.2.1 Compliance audit of on-lending activities

A compliance audit of on-lending activities can be conducted by an SAI to assess whether loans for on-lending were secured in accordance with relevant laws, regulations, policies and prescribed processes, and whether the terms of the PLA and SLA had been complied with by all parties. The following are possible audit objectives for on-lending activities:

- To ascertain whether loans contracted for on-lending conform with relevant laws, regulations, policies and processes;
- To determine whether the terms of the PLA and SLA had been observed by the concerned parties to the agreements; and
- To ascertain whether loans were on-lent to borrowers in accordance with the purpose(s) agreed to in the PLA/SLA.

8.2.2 Performance audit of on-lending activities

An SAI can conduct a performance audit of on-lending activities to ascertain the following:

- The economy, efficiency and effectiveness of the scheme for financing investment projects;
- The efficiency and effectiveness of the DMOs in the risk assessment for on-lending activities and in the implementation of mechanisms to reduce the related identified risks; and
- The performance of on-lending entities or borrowers in terms of repayment of on-lent loans and its impact on the government's fiscal position.

The following are audit objectives which can be considered in a performance audit of on-lending activities:

- To determine whether the use of on-lending is an economical, efficient and effective means for funding the government's investment projects;

- To ascertain whether the on-lending entity has efficiently and effectively undertaken risks assessment for on-lending to borrowers and the implementation of risk mitigation strategies; and

- To determine the adequacy and timeliness of the government's response to non-payment of on-lent loans by borrowers.

8.3 Representative Audit Questions on On-lending Activities

Audit objective: To determine whether the use of on-lending is an economical, efficient and effective means for funding a government's investment projects

1) Are there other options considered in financing the government's investment projects? If yes, what are they?

2) Is there a detailed study or analysis undertaken in the use of on-lending for investment projects? If so, what are the results?

3) What are the costs involved in on-lending by the government?

4) What are the processes involved, and were they undertaken efficiently?

5) Compared with other financing schemes, has on-lending been determined to be the best alternative for investment projects in terms of cost?

Audit objective: To ascertain whether the on-lending entity has efficiently and effectively undertaken the risk assessment for on-lending to borrowers and the implementation of risk mitigation strategies

1) Does the on-lending entity have clear policies for on-lending to borrowers and beneficiaries?

2) Does the on-lending entity consistently undertake risk assessment and at periodic intervals?

3) Have mitigation strategies been developed for identified risks?

4) Are there cases where identified risks have actually occurred? Were the mitigation strategies implemented? Have they been assessed to be effective or ineffective?

5) Has the on-lending entity been efficient in undertaking the risk assessment of on-lending activities?

6) Has a risk register for on-lending activities been prepared, disseminated and periodically updated?

Audit objective: To determine the adequacy and timeliness of the government's response to non-payment of on-lent loans by borrowers

1) Has the on-lending entity ensured that statements of accounts or billing statements are received by borrowers within a period which allowed borrowers to make payments on time?

2) Is there a prescribed process for informing the government of the borrower's inability to settle particular repayments due?

3) What are the remedies available in case of inability of borrowers to settle their obligations when due?

4) Have all borrowers of on-lent loans made repayments in the full amount due and within deadlines?

5) How has the government prepared for incidences of non-settlement of amounts due from borrowers?

6) Have there been instances when repayments to the principal lender or financial institutions not been settled on time due to late notice from the borrowers of their inability to pay amounts due to the government?

7) Is there a provision in the national budget for the government's advances for repayments to the principal lender or financial institution for on-lent loans, or are there dedicated sources of funds?

8.4 Audit Criteria for On-lending Activities

The DeMPA Tool evaluates the on-lending activities within DPI-10 (Loan Guarantees, On-lending, and Derivatives). Dimension 2 of that performance indicator assesses the government's on-lending activities by looking at the availability and quality of documented policies and procedures for approval and issuance of central government on-lending. To ensure the sound management of on-lending transactions, credit risk assessment and analysis of the financial impact if the on-lending beneficiary fails to repay the loan should be regularly conducted. Moreover, government assets used for lending purposes should be a subject of regular monitoring.

UNCTAD Principles 5 and 12, in the context of project financing, focus on the needs of ex-ante evaluation of the project to be financed from the borrowed funds. 'Lender's responsibility to investigate a project that is being funded with public monies does not relieve the sovereign borrower of its independent responsibilities in this regard'.

8.5 Sources of Evidence in Auditing On-lending Activities

The SAIs may use the following sources to collect evidence or understand the on-lending activities:

- Operational guidelines for government on-lending, including the method for calculating on-lending fees, risk assessment and reporting of on-lent funds;
- Original loan between the government and the initial lender; and
- Subsidiary agreements between the government and the final borrowers.

8.6 Illustrations of Audit Findings on On-lending Activities

In the audit of on-lending activities, an SAI observed the following:

1) Absence of comprehensive on-lending policy document

The 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 organisation 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, the debtor selection process does not include the due diligence activities and at the moment loans are extended to the companies in financial difficulties.

2) Unassessed risks on on-lending activity and absence of related guideline

The risks related to the on-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 reorganising) the loan to the entity whose financial situation does not guarantee the loan repayment is ambiguous.

3) Ineffective monitoring for performance of on-lending agreements

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 sufficient information about the financial soundness of the borrower and does not ensure the identification of the potential problems in debt servicing.

4) Deficient recording and publication practices for on-lent loans

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 the portfolio is not disclosed publicly, neither by means of web sources nor in the budget documents. Therefore, the transparency of the data is not ensured.