PN-ACA-360

DEVELOPING A LOAN GUARANTEE PROGRAM FOR THE CZECH STATE FUND FOR THE ENVIRONMENT
REVIEW, BACKGROUND, AND RECOMMENDATIONS

ENVIRONMENTAL ACTION PROGRAMME SUPPORT PROJECT
Contract DHR-0039-C-00-5034-0

Prepared for:
Brandon Prater
Contracting Officer's Technical Representative
U.S. Agency for International Development

Provided to:
The Czech Republic State Fund for the Environment

Prepared by:
John W. Haines, Chemonics International Inc.
Richard J. Lewis, Ernst & Young
L. Warren Townsend, Ernst & Young

August 23, 1996

EAPS Project • 1133 20th Street Northwest, Suite 600 • Washington, DC 20036 • Tel. (202) 955-3300 • Fax (202) 955-5574
Funded by USAID • Implemented by Chemonics International Inc. • Dames & Moore • Environomics • Ernst & Young LLP • Harvard Institute for International Development • Industrial Economics, Inc. • Institute for Sustainable Communities • K&M Engineering and Consulting Corp.

TABLE OF CONTENTS

2

EXECUTIVE SUMMARY

The Czech Ministry of the Environment, operating through the Czech State Fund for the Environment, provides considerable financing to municipalities and businesses in support of investments that improve the environment. Most financing is provided in the form of grants and subsidized loans. These grants and loans are extended directly by the Fund to the municipalities and businesses undertaking the improvement project.

The Ministry and the Fund have recently taken keen interest in exploring the use of loan guarantees as a means of extending financial support. Under such an arrangement, a loan would be extended by a commercial financial institution, not directly by the Fund. The Fund would provide the commercial lender a guarantee of the borrower's repayment obligation. To maintain the desired incentive and ensure that loans were affordable, the Fund would concurrently provide a subsidy to the borrower. These guarantees would supplement the Fund's current reliance on direct loans and possibly eclipse them in the years ahead.

This report is intended to help the Ministry and the Fund to evaluate the nature, advantages, and risks of loan guarantees as a means of stimulating environmental investments. It emphasizes several significant ways in which a carefully structured program of guarantees would promote environmental amelioration and the sound financing of environmental investments. The potential benefits are these:

- To expand the amount of capital available for environmental investment by establishing a relationship of collaboration between the Czech Fund and the commercial lenders
- To encourage efficiency in the design, construction, and use of environmental facilities
- To protect municipal lenders from overextending themselves by borrowing beyond their means
- To promote the maturation of a commercial, rather than a subsidized, system of local-government finance
- To reduce the risk of default by municipal borrowers
- To supplement the administrative and analytical capacity of the Fund with the specialized skills of the commercial banks.

The report proposes that the ministry adopt a policy favoring the use of guarantees. Emphasizing that guarantees carry risks comparable to loans issued directly, the report cautions that policies, procedures, controls, and other safeguards are critical to a successful program.

The ministry has recently authorized the issuance of six particular loan guarantees but did so in the absence of the protection that comes with sound policies and procedures. At least some of the proposed transactions appear to be unsound. The ministry should exercise the greatest of care in moving to implement these guarantees. The failure of any of them would be costly, both in lost capital and—more significantly—in jeopardizing the Ministry's potential to realize the benefits of a well-conceived program of guarantees.

SECTION I

GUARANTEES AND GUARANTEE PROGRAMS

SECTION I
GUARANTEES AND GUARANTEE PROGRAMS

This section describes the types of guarantors (guarantee providers), common types of guarantees, a generic structured guarantee program, components of a guarantee policy, and the benefits and opportunities of a guarantee program.

A. Overview

The Czech State Fund's sources for financing environmental improvements are drying up as pollution fees and fines dwindle and transfers from the National Property Fund for air improvement are exhausted. Although the Fund is receiving more revenues from loan repayment, its funding sources cannot meet the country's environmental finance needs. The Czech Ministry of Finance and the Czech Central Bank recently issued recommendations that the Fund devise alternative forms of support to leverage its limited resources. This policy change is consistent with a 1995 Environmental Action Programme Support (EAPS) that the Fund engage commercial banks as partners in its financing programs. The Fund's financial director, Mr. Jaroslav Nevyjel, and his staff have begun research into guarantees and should be acknowledged for making important first steps toward shaping policies and procedures for guarantees.

Czech banks have not been active lenders in environmental project financing because they cannot compete with the Fund's generous repayment terms and subsidized interest rates. Nevertheless, the banks apparently consider the municipal sector an attractive market due to the generally lower credit risk in comparison with loans to the commercial sector.

The purpose of this report is to help the Fund and the Ministry of the Environment evaluate the risks of and opportunities for offering loan guarantees. The report examines the risks the Fund currently faces from its involvement in guarantees, reviews existing guarantee programs in the Czech Republic, and provides general information on guarantees, guarantee policies, guarantee programs, and the opportunities such programs offer the Fund. This report does not recommend an exact structure for the Fund's guarantee program. Such a recommendation will be part of a longer-term EAPS consultancy and will require additional information from the Czech financial markets, as well as a number of actions by the Ministry of the Environment and the Czech State Fund.

B. Guarantors, Guarantees, and a Structured Guarantee Program

A guarantee is a flexible and adaptable credit enhancement and legal device that offers assurance to a lender that a stipulated performance, usually loan repayments by a borrower, will be met. A guarantee can take many forms and is a common tool used to mitigate and spread financial risk and credit exposure among participants in a financing transaction.

In considering the Czech State Fund's use of loan guarantees, it may be helpful to separate guarantees into two broad categories. One category involves guarantees that are used in a specific way on a case-by-case basis; these are usually associated with large projects involving high costs and complicated financing schemes. Project financing, especially for complex construction projects, typically has a high debt to equity ratio. The project sponsor relies on guarantees, often its own if it has the financial strength but also those of one or more third parties, to mitigate and spread risk so banks will finance construction through completion and testing of the project.

Project-related guarantees can take many forms and are usually devised to cover a particular element of a project's risk. The gurantee's scope can be limited or not, depending on the project's circumstances and its participants. Once construction and start-up testing have been completed, term guarantees may be used to protect the lenders providing the long-term or "take-out" financing.

The second category of guarantee involves a standardized or structured financial product. This *structured guarantee program* tends to involve less complicated financing schemes and is used to support the delivery of credit to a large number of similar borrowers or projects.

Following are descriptions of the types of guarantors (guarantee providers), several common types of guarantees, and a generic structured guarantee program.

B1. Types of Guarantors

Guarantors are of two general types: owners and third parties.

Owner guarantors. Owners are the logical guarantors of their project's financing, but only the strongest international and domestic firms are acceptable to financial institutions as reliable guarantors. Typically, even within a financially strong industrial group, the project owner and operator will be an undercapitalized subsidiary of the parent company. As a result, financing institutions require the parent company's guarantee. In the Czech Republic, the sponsors of a project typically may be entrepreneurs without sufficient credit standing to guarantee the financing of their project. Therefore, lenders will seed third-party guarantors.

Third-party guarantors. Third-party guarantors are of five types: contractors who will build or operate the project; suppliers of services or products to be used in or by the project; sellers of the project's output; users of the project's output; and government agencies interested in the successful completion and operation of the project. The Czech Fund falls into the last category. The most important factors in a financial institution's evaluation of a third-party guarantee are the guarantor's financial strength, reputation for integrity, and legal ability to guarantee. In the case of the Fund, the ability to act as a third-party guarantor, and limitations that may apply to guarantees issued by the agency, must be clearly stated in national law. In addition, the financial strength backing the agency's guarantees must be apparent to and not in doubt by beneficiaries of the guarantees. If the full "faith and credit" of the state does not back the guarantees, what backing exists, such as bank deposits and other liquid investments, must be disclosed for the public's benefit.

B2. Types of Guarantees

Guarantees are of five general types: direct and unconditional, limited, indirect, contingent, and special purpose.

Direct and unconditional. Under this type of guarantee, the guarantor assumes responsibility for the obligations of the guaranteed party. Based on resolutions issued by the former Minister of the Environment, this is apparently the type of payment guarantees the Fund expects to issue. Other forms of guarantees provide less support to the lender but are still satisfactory for the transaction or project to be financed.

Limited guarantees. Guarantees may be limited in amount and time. They may cover less than 100 percent of the lender's exposure, and they may cover deficiencies such as a cash flow shortfall, cost overruns, and excess operating expenses, all of which would affect the ability of the borrower to service debt. They may cover only a project's construction start-up period and leave the long-term risk uncovered (see completion guarantees below), or they may cover only the long-term financing.

Indirect guarantees. These guarantees ensure the sale of a project's output or the provision of its necessary inputs.

Contingent guarantees. The primary purpose of these guarantees is to protect the lender from becoming the equivalent of an equity holder. Such a guarantee may be made on the basis of some event beyond the control of the project parties, for instance, a change in price, an action of government, or an act of God. Lenders want such risks to be assumed by the owners and sponsors, other interested parties, or governments.

Specific purpose guarantees. These guarantees are of two types: the payment guarantee and the completion guarantee.

- **The payment guarantee** ensures borrower performance for a lender. It may, for example, provide for payment of missed installments, payment of the outstanding loan balance after a certain number of installments have been missed, or payment of the balance of a construction loan when there is no long-term take-out of the amount due or when the completed project does not perform to specifications and long-term financing is not available. The guarantee usually also provides for the payment of interest.

- **The completion guarantee** provides that a project, such as construction of a natural gas plant or waste incinerator, will be completed and operate in accordance with stipulated specifications of the construction contract. The guarantee is arranged by the project sponsor and may run in favor of the short-term lender during the construction phase of the project and the long-term lender (often the same financial institution) when the project is completed. The guarantee undertakes to complete the project within a specified period to pay any cost overruns.

B3. The Structured Guarantee Program

A structured guarantee program can include any of the above types of guarantees. Guarantee programs are used worldwide to promote and leverage financing to a targeted market of borrowers and projects. Programs differ in as many ways as the objectives of guarantee providers, capabilities of target recipients, and the sophistication of the financial or capital markets. Most guarantee programs are established for specific objectives such as economic development, environmental improvement, infrastructure construction, poverty alleviation, and employment.

In general, guarantee programs extend a commitment made by a financial institution to pay a percentage of a loan. This percentage is paid either upon installment default (payment guarantee) or after the lender has liquidated collateral (balance of loan guarantee). The percentage can be fixed, graduated, or tiered, and usually continues for the life of that loan. The exact terms of a guarantee program often are adjusted by the guarantor (guarantee provider) to meet financial market conditions as they evolve. In this way, a guarantee program can be a highly flexible and adaptable financial tool. Guarantees can also be used with other forms of credit support such as equity grants, interest subsidies, or buy-downs and debt service reserve funds.

The following elements, discussed below in Section C, define a structured guarantee program:

- **Eligibility** requirements that define the target market and guarantor's objectives

- **Criteria** including the credit risk, loan size, use of proceeds, and collateral

- **Terms** including guarantee percentage, term of the loan, term of the guarantee, interest rate, and fees and charges

As capital markets evolve in the Czech Republic and allow for wider use of revenue bonds to support municipal projects, a guarantee program can be adjusted to support that market. In the United States, many states have established revolving guarantee funds to support wastewater treatment facilities associated with water pollution control laws. The objective of the guarantee funds, which were established through a combination of Federal and state grants, is to leverage their limited capital resources to encourage and support bond financing for water improvement. The funds use their reserve funds as collateral security to borrow in the public bond market. These guarantee funds are often referred to as revolving funds because the capital base and the interest earned on that base serves as an ongoing source of revenue to support project financing. These funds use interest income on their reserves to provide a sustainable source for supporting interest rate subsidies and capitalization grants. (The value of the interest earnings on a guarantee reserve fund illustrates the importance of the Fund's obtaining a waiver from the withholding tax on interest income.)

C. Components of a Guarantee Policy and Guarantee Agreement

A guarantee policy typically is not a stand-alone document but is incorporated in the organization's general policy on credit risk management. A guarantee carries the same risks as a direct loan and sometimes carries additional disguised hazards. A policy should be adopted and adhered to at all levels of the Ministry of the Environment and the Fund's decision-making structure. It should be communicated publicly and must be understood by applicants and financing institutions. The following are 14 areas covered by a standard guarantee policy:

- Goals and objectives of a guarantee program
- Eligibility requirements
- Limitations
- Standard evaluation criteria
- Application procedures
- Disbursement policy
- Authority for issuance of guarantees and modification of terms
- Approval of participating banks
- Duties of participating banks
- Risk rating and loan loss reserve calculation
- Acceptable collateral for guarantees
- Issuance fees
- Accounting disclosures
- Revision and review of the policy

4

C1. Goals and Objectives of a Guarantee Program

A policy statement should begin with a specific list of the guarantee program's goals and objectives. Examples might be:

- Expand the number of environmental projects financed (by a certain percentage goal) by leveraging limited Fund resources to induce bank financing capabilities

- Target and identify projects that do not qualify for standard bank financing

- Provide support to designated environmental sectors

- Induce bank participation in longer-term loans to meet the debt service ability of the borrowers

- Utilize bank resources in credit analysis, loan disbursement, and loan monitoring to reduce overall credit risk and improve the quality of the project evaluation

- Reduce the administrative burden on Fund personnel to allow them to focus on improving the credit quality of the Fund's existing loan portfolio

- Provide for a balanced portfolio mix, ensuring that grants, direct loans, and guarantees represent a predetermined ratio of Fund assistance

C2. Eligibility Requirements

This portion of the policy should define the eligibility of the projects based on the following sample criteria:

- Type (air, water, soil, waste, nature protection, etc.)
- Geographic distribution
- Forms of ownership
  - Municipality
  - Private enterprise
  - Nonprofit enterprises
  - Foreign ownership
- Maximum and minimum size of project financing to be covered by the guarantee
- Environmental benefit
- Eligible project costs, including or excluding land, buildings, and equipment acquisition; site preparation; construction of new or reconstruction of existing infrastructure; cleanup of hazardous waste; excavation; and engineering costs

C3. Limitations

A guarantee policy should specify its limitations. Some possibilities include the following conditions:

- The total guarantees (in Kc) issued in any single fiscal year will not exceed an established amount.

- The combination of a grant, direct loan, or a guarantee to any single borrowing entity or its related interests shall not exceed a certain percentage of the Fund's reserves.

- No guarantees will be issued for projects where the loan proceeds are to be used for operating costs, debt refinancing, or non-environmental capital improvements.

- The Fund guarantee shall not be for maturities beyond a specific term as determined by the characteristics of the borrower and project debt service ability.

- Guarantees will be granted only to debtors with a satisfactory credit rating.

- Guarantees will be offered only on projects where the project participants, including construction company and operating entity, have successfully completed similar projects of type and scope within a certain period (for instance, three years).

- Guarantees will have a geographic or district dispersal.

C4. Standard Evaluation Criteria

The policy should specify the evaluation criteria for each application. This would apply to direct loans as well as guarantees. Possible criteria include:

- Evidence that the applicant is unable to obtain conventional financing without the Fund guarantee

- Evidence of environmental justification for the project, with certification that it is considered a local or regional priority

- Cost estimates and other figures for the project prepared and verified by a qualified professional engineer; the Fund should have the right to verify the quality and accuracy of the cost estimates to be evaluated

- Detailed work program and evidence that the project is ready to proceed promptly provided by the applicant

- Detailed financial plan from the applicant/developer to accommodate the work schedule, with sources and uses of financing identified to ensure an adequate cash flow for the construction and testing phases; a contingency factor (for instance 10 percent) should be built into the cost estimates

C5. Application Procedures

The Fund should adhere to specific steps for processing information submitted either by a creditor bank or jointly with the project applicant. This will differ from the standard process for a direct loan because in the case of the guarantee, the loan may already have been approved by a bank subject to receiving the Fund guarantee. Application steps might include the following:

- All applications for Fund guarantees will be in writing and fully documented according to established Fund standards.

10

- The Fund will review each application to determine eligibility and whether the project will be competitive for funding given the level of available appropriation for guarantees in a fiscal year.

- The Fund will advise the bank or applicant in writing of its decision. If the decision is negative, the Fund will specify the reasons for the rejection.

- If the guarantee is approved, the Fund will prepare a guarantee agreement and have it jointly executed by the applicant or debtor, funding bank or creditor, and the Fund or guarantor.

- The Fund will provide public advertisement of the approval at both the local and national level through appropriate media.

C6. Disbursement Policy

The Fund will also get participating banks and applicants to execute a disbursement schedule.

- The project applicant's equity capital will be contributed first and deposited into a bank account under the control and dominion of the bank. The applicant's funds will be used to pay project costs or invoices prior to the bank's loan financing.

- Each request for disbursement to the bank will be in writing and will be based against the cost estimates provide by the applicant.

- The bank or its agent will conduct periodic site inspections to verify the level of project completion.

- Each request for disbursement will be accompanied by copies of invoices for approval and review by the bank. On the Fund's request, the bank will make this information available to the Fund.

- Within 60 days of project completion, a certified audit by a chartered accountant will attest that funds were disbursed in accordance with the cost estimates and the terms of the guarantee agreement. The bank will confirm it has followed the provisions of the guarantee agreement. Failure to do so will negate the Fund guarantee.

C7. Authority for Issuance of Guarantees and Modification of Terms

The policy should detail the approval hierarchy for the issuance of a guarantee and the modification or amendment of any significant terms or conditions. This policy area should indicate the necessary precedent approvals required, including the bank commitment, Fund technical and financial recommendation, Fund Council recommendation, minister approval, and other sanctioning bodies as required.

C8. Approval of Participating Banks

The policy should describe the Fund's criteria for qualifying participating lenders. The most significant should be the lending institution's experience in financing certain sectors and the

11

size of the bank relative to the scope of the transaction. For example, no bank should fund a project on its own in an amount greater than 15 percent of its capital base. This implies that some large projects may need the syndication of several banks. The potential participating banks' loan loss experience and the ability of a bank's lending personnel should be considered in the Fund's decision to approve participating banks.

C9. Duties of Participating Banks

This area will define the key duties and responsibilities of the creditor bank.

- Conduct a complete credit analysis based on the cash flow of the investor and the project to be financed. Copies of the analysis and relevant supporting documentation are to be provided to the Fund for review.
- Prepare a detailed loan agreement, collateral analysis, and all pertinent loan documentation. Copies are to be submitted to the Fund for review and approval.
- Manage the disbursement of loan proceeds in accordance with a jointly approved disbursement agreement.
- Engage the necessary field personnel to ensure proper use of loan proceeds.
- Collect interest and principal in a timely fashion, and report quarterly to the Fund all outstanding balances of individual borrowers.
- Report to the Fund promptly, within 30 days, any evidence of deterioration in the borrower's financial condition, payment delinquency, or other violations of the loan agreement that could place the loan in jeopardy of default.
- Exert full collection efforts to keep the borrower current with its obligations, and maintain a detailed written record of that collection effort.
- Assign and transfer all documentation in a complete and accurate form to the Fund for review before payment on the guarantee.
- Advise the Fund immediately if the bank, due to operational deficiencies, is unable to comply with the terms of the guarantee agreement.

C10. Risk Rating and Loan Loss Reserve Calculation

Risk rating. Each Fund credit commitment, whether a direct loan or a guarantee, should be assigned a risk rating. For guarantees, the Fund should consider both the operating and financial risk of the lender. The Fund, after all, will be relying on the bank to disburse the loan, collect the principal and interest, and secure collateral. If the bank fails to do this, the credit of the borrower may deteriorate, jeopardizing the Fund's guarantee. The Fund therefore should be diligent in evaluating lender operations. Such an assessment is an essential supplement to the more traditional financial assessment. Both the operational and financial strengths of the lender must be considered in establishing the loan loss reserve.

12

Loan loss reserve calculation. Rather than using a 20 percent reserve, as is the practice now, the Fund should adopt the methodology used by commercial banks. Another alternative is a reserve for each risk level according to the following (as an example):

• Minimal risk	10%
• Average risk	15-20%
• Above average risk	35%
• Collection doubtful	50%
• Probable loss	100%

The reserve should be calculated quarterly and its adequacy approved by all of the Fund's senior management, the Fund Council, and the Minister of the Environment. Implementing a reserve policy based on banking practices will help assure the bank market of the Fund's ability to support its guarantee commitments and manage its financial operations.

C11. Acceptable Collateral for Guarantees

Generally, collateral for a guarantee should be the same as for a direct loan. The major difference is that under a guarantee program, the Fund will most likely transfer the responsibility to monitor and protect the value of the collateral to the bank. As the Fund is one step removed from the collateral because of the bank involvement, the Fund may wish to seek extra collateral coverage.

As security, the Fund should at least take the project facility financed with the proceeds of the loan. Even though this may be a special-purpose property and of limited marketability, it will likely have the ability to generate revenue.

The fund might consider taking collateral in the form of a debt service reserve fund, with liquid assets (cash or marketable securities) as the collateral.

The policy should state emphatically that an abundance of collateral is not an appropriate substitute for deficiencies in the debt service capabilities of the borrower. Collateral does not make loan payments. If cash flow and debt service coverage is insufficient, the collateral coverage must not be the sole reason for approving a guarantee. The project should be rejected, or the Fund may want to consider project support in the form of a grant.

C12. Issuance Fees

While it has not been customary for the Fund to collect issuance fees for project guarantees, it should receive compensation for the services it provides. The fees for issuing guarantees and penalty fees for defaults should be outlined in the Fund's guarantee policy. Fees should be collected from the borrower before loan disbursement and collected annually on the anniversary date of the guarantee agreement for the life of the guarantee. The amount collected annually would be based on a percentage of the then-outstanding loan balance (or the Fund's guarantee exposure).

If the Fund establishes a payment guarantee, the policy should detail the interest rates on borrower defaults and on any advances made to the bank under a payment form of guarantee. In general, the Fund rate should be contractually equal to or greater than the bank rate so as not to

13

create an incentive for the borrower to default on its obligation to the bank. This should also include penalties to the borrower as a disincentive for default.

C13. Accounting Disclosures

The Fund should recognize the aggregate value of outstanding guarantees as a contingent liability on its balance sheet. It should also offer a narrative paragraph on the overall credit risk level attached to the guarantees and make appropriate reference to the adequacy of the separate loan loss reserve established for the same.

C14. Revision and Review of the Policy

The policy should be reviewed at least annually for its completeness and practical application. The Fund should scrutinize violations of policy, particularly examining whose authority allowed the violations and what corrective action has been taken. The policy should be adjusted as financial markets evolve and the objectives of the Ministry of the Environment change.

D. Benefits of a Guarantee Program for the Ministry of the Environment and the Czech Fund

1. Allows the Fund to manage its resources efficiently by delivering credit to where it creates the greatest environmental benefit

The potential flexibility of guarantee terms allows the Fund to adjust the terms among its environmental sectors (air, water, waste, nature protection, commercial) to encourage lending in a specific sector.

2. Leverages limited public resources to encourage private sector financing

The demand for Fund assistance far exceeds its available resources. The opportunity to efficiently leverage this capital base as a revolving source of support could have a multiplier effect on the financial market.

3. Helps fulfill a credit supply gap for environmental investments

The leveraging of Fund resources through a guarantee will place more funds into environmental investments. This will help alleviate a capital shortage for environmental projects.

4. Institutionalizes alternative financing mechanisms for environmental projects with the domestic credit market

Bank and financial market acceptance of a guarantee product could help create a long-term relationship between the Fund and the financial community to finance environmental improvements. A guarantee program can provide the needed incentive for banks to enter and expand their relationship with the large and valuable environmental improvement market. As banks learn about the environmental sector, they will likely adapt their services to meet the needs of the environmental market.

14

5. *Increases efficiency of the Fund by sharing the financial analysis and monitoring burden with the banks, thereby providing the fund with the means to better manage its credit risk*

By requiring participating banks to perform high-quality analysis and monitoring of guaranteed loans, the Fund eliminates the administrative burden of analyzing the projects itself.

6. *Provides an opportunity to lengthen loan terms*

By altering the percentage guarantee offered to the bank (offering a higher guarantee percentage for long-term loans), the Fund could encourage banks to lengthen their loan terms on projects requiring a longer debt-service term.

7. *Limiting the risk and credit exposure of the banks potentially lowers the borrower's interest rate and effectively provides an indirect interest subsidy*

The guarantee extends to the banks a credit enhancement that should translate into lower interest rates (because the risk is lower to the bank) charged to the borrower.

8. *Increases the Fund's transparency to applicants and the credit market, thereby reducing the possibility of politicized and inadequately evaluated decisions*

A defined, structured, and communicated program will help the Fund avoid risks associated with unsubstantiated and risky credit decisions (as evidenced by the current resolutions to guarantee offered by the previous Minister of the Environment). An effective guarantee program requires policies and procedures that will make the decision-making process more transparent and open to the public.

9. *Helps improve the sustainability of the Fund*

A guarantee reserve used as a revolving fund creates an ongoing role for the fund in a market economy. The reserve serves as a capital base from which future guarantees and other environmental programs can be shaped for the financial markets. The use of a guarantee program supported by a funded reserve allows the Fund to leverage that reserve (from two to five times the Fund's reserve, depending on the risk associated with the guarantees) to encourage bank or capital market financing.

SECTION II

GUARANTEE PROGRAMS IN THE CZECH REPUBLIC

SECTION II
GUARANTEE PROGRAMS IN THE CZECH REPUBLIC

A. Agriculture Department Guarantee Program (Podpurny a Garaneni a Rolnicky Lesnicky Fond (PGRLF) a.s.)

A1. Background

The Podpurny a Garaneni a Rolnicky Lesnicy Fond (PGRLF) operates under the Ministry of Agriculture and was established in 1994 to deliver loan guarantees to entrepreneurs engaged in agricultural and forest activities. As of July 22, 1996, the fund had guaranteed 7,294 loans from 7,912 requests (92 percent approval rate) for nearly Kc26 billion in total bank financing. Another Kc19.3 billion in loans seeking the fund's guarantee were pending on the same date. The average loan size guaranteed by the fund is approximately Kc3.2 million, but the fund also has extended guarantees for larger loans to Kc100 million. Of the Kc26 billion of bank financing extended thus far, the fund has guaranteed Kc11.3 billion or an average of 44 percent of the total bank financing. Forty domestic and foreign banks have participated in the program, but the primary banks have been Komercni Banka, Agrobanka, and Ceska Sporitelna.

The PGRLF offers a *payment guarantee,* usually in companion with an interest subsidy. This form of guarantee assures the bank that individual defaulted installments will be paid. This guarantee differs from a *balance of loan guarantee*, which is paid to the bank after default and full execution and realization of collateral interests by the bank.

The maximum guarantee percentages are tiered based on the loan's term:

- Maturity within 2 years, 50 percent
- Maturity within 5 years, 50 percent
- Maturity greater than 5 years, 85 percent

The PGRLF's board and advisory board include members from the Ministry of Finance and the Czech National Bank. Before initiating its guarantee program, the fund published the objectives, conditions, and parameters of the program and made the information available to potential guarantee recipients and participating banks.

A2. Relationship with Borrowers and Banks

Applications for guarantees flow from the borrower to the bank and from the bank to the fund. The fund does not have direct contact with the applicants except through the applicants' banks. The fund provides banks with guidelines establishing the conditions for cooperation and a standardized guarantee agreement that is adapted to the terms and conditions of each credit for each guarantee extended. The fund also provides financial statements twice a year to each participating bank.

The fund does not screen or qualify participating banks or evaluate their credit analysis capabilities. It relies on the credit review of the participating bank but does not require a copy of the bank's credit analysis. Further, the fund does not perform financial analysis on its own but reviews projects only for their adherence to program guidelines after bank approval (a staff of seven performs this function).

The bank is required to provide the fund with information on the payment performance of the guaranteed loans twice a year. Upon loan default, the bank has the choice of receiving the repayments in installments or in lump sum to the extent of the guarantee percentage. The fund does not obtain a collateral agreement with the borrower. According to senior staff at PGRLF, the Czech trade code allows them to pursue collateral upon default without establishing this before the extension of credit or a guarantee. The fund does not charge a guarantee fee.

A3. Performance

The PGRLF's guarantee program has had good experience with loan repayments in its 2 ½ years, particularly with its smaller guarantees. As of July 22, 1996, 2,078 loans totaling Kc6.6 billion, 43 percent of them guaranteed, have been repaid. The fund reserves a flat 10 percent of its guarantee commitments and, as of July 22, 1996, has Kc60 million in loans in default (0.5 percent of its guarantee commitments), according to fund officials. The fund's 1995 fiscal financial statements, however, listed a total of Kc494 million in loans in default (approximately 5 percent of the fund's outstanding guarantee commitments). The problems are concentrated in several large loans (8 loans make up Kc310 million of the defaults).

The fund and bankers who have relationships with the fund attribute the quality of the fund's borrowers to the nature of the collateral taken and its value to the borrower, and the characteristics of the communities where the loans are given. According to bankers and fund officials, neighbors tend to know which persons in their community have received loans, and they know if a default occurs. This peer pressure, which may be unique to the agriculture and forestry sectors, has had some positive influence on borrower loan repayment.

A4. Comments and Lessons

The PGRLF initially researched the possibility of establishing a balance of loan guarantee program in which the guarantee is paid on the remaining loan balance (to the extent of the established guarantee percentage) after the loan's default and the bank's complete action on collateral realization. This balance of loan guarantee is similar to the Czech-Moravian Guarantee Bank's (CMZRB) current guarantee program (see below). The fund chose the payment guarantee instead because banks consider the terms more advantageous and less risky. Based upon bank response, as evidenced by the number of loans extended and the number of banks involved, the fund is effectively meeting its mandate to accelerate funding to the entrepreneurial agriculture and forestry sector.

- PGRLF's loan defaults are concentrated in its large guarantees. The characteristics of these loans (leveraged transactions) might provide insight into reasons for company failure and default that could assist the Czech Fund with its potentially large guarantee commitments.

- Most PGRLF guarantees have an associated interest subsidy. One disadvantage of this is that it creates a disincentive for borrowers to pay their loans early. As a result, the interest subsidy causes a longer commitment of the fund's reserves and resources are not recycled into new guarantees as rapidly as they should be.

- The guarantee program was well defined before its introduction and appears to have been communicated adequately to clients and banks. This has helped the fund avoid confusion in the market and has resulted in a favorable public impression of the fund and strong bank support for the targeted market.

- Banks report loan repayment to the fund every six months. Although this has not caused a problem for the fund, it has the potential to delay recognition of slow-paying credits and affect the fund's ability to assist in managing the workout. Quarterly or monthly reporting would enhance the guarantee provider's ability to manage its risk exposure, loss reserves, and workout strategies.

- The use of a higher guarantee percentage for longer-term loans has apparently induced banks to offer extended loan terms.

B. Czech-Moravian Guarantee and Development Bank-Ceskomoravska Zarucni a Rozvojova Banka, a.s. (CMZRB)

B1. Background

This bank was established in 1992 to support small and medium enterprises (under 500 employees). The Ministry of the Economy owns 49 percent and the 5 largest Czech banks own 51 percent. The guarantee program is the most important of several state-run and foreign assistance programs directed at the commercial sector and, to a lesser extent, the municipal market (through the U.S.-backed MUFIS program). In 4½ years, the bank has extended over 1,500 guarantees totaling more than Kc10 billion in loans, Kc6 billion of which has been guaranteed by CMZRB. The average loan size guaranteed by the bank is Kc6 million and the maximum, by policy, is Kc30 million. The average percentage of the loan principal guaranteed has ranged from 50 to 75 percent (CMZRB lowered its guarantee percentage in response to losses in 1994-1995 but increased the percentage to 70 percent in 1996 to stimulate demand). The bank has cooperation agreements with more than 40 domestic and foreign banks.

Under its former payment guarantee program (which has been phased out) CMZRB guaranteed up to 85 percent of the principal balance of bank loans and charged the borrower a risk-based exposure fee (independent of the interest rate charged by the lending bank) of up to 9.3 percent, most of which was paid by the state in the form of a subsidy. According to one bank official, this exposure fee funds CMZRB's guarantee reserve. The fee is charged annually against the outstanding guarantee exposure on each loan. Because of a high number of loan defaults and strain on the reserve under the payment guarantee agreements, CMZRB requested and received approval from the Ministry of Finance to raise this exposure fee percentage by 4 percent to supplement its reserve fund. Under a default, the banks could demand full payment of the guarantee or the installment amounts.

Although CMZRB initiated its guarantee programs with a payment guarantee, it has since established a balance of loan guarantee because of the higher risk involved in the payment guarantee structure and greater staffing and administrative costs. Under the balance of loan guarantee, CMZRB continues to receive the exposure fee but only guarantees up to 70 percent of the balance of the loan. The primary difference in the guarantee is that CMZRB does not pay individual installments but pays on its guarantee only after default and the participating bank's execution of its collateral interest.

Changes in the program's structure have lessened the CMZRB's risk of exposure and, by extension, its reserve funding requirements. The demand for guarantees from participating banks, however, has diminished substantially.

B2. Relationship with Borrowers and Banks

CMZRB establishes cooperation agreements with participating banks that communicate the conditions of the guarantee program. Applications are made to CMZRB and the lending bank. CMZRB analyzes each guarantee extension and does not require or receive the loan assessment or analysis from the bank providing the loan (according to a CMZRB officer, participating banks are hesitant to provide this information to a competitor). CMZRB's account officers handle a portfolio of 50 to 60 guarantee customers.

Under the payment guarantees, CMZRB holds pledged collateral, often term deposits, from guarantee customers as collateral for its guarantee obligation. CMZRB originally did not stipulate the percentage of collateral coverage it required from borrowers. However, it quickly established a minimum of 20 percent, raised it to 50 percent, then 70 percent, the current rate. The increases responded to problems with defaults. Under the balance of loan guarantee, all collateral is assigned to the lending bank.

B3. Performance

CMZRB experienced problems with credits extended to food production companies, especially bakeries. In response, CMZRB has shifted its portfolio gradually toward the service sector and away from food production manufacturing. It also has ceased to offer the payment guarantee, in favor of the balance of loan guarantee. The bank attributes its problems with defaults to economic circumstances, the inherent risk of the new entrepreneurial sector, and its concentration in the food processing area of the manufacturing sector.

B4. Comments and Lessons

- Payment guarantees usually involve greater risk for the guarantee provider and require higher reserves to fund defaulted payments.

- The option of holding liquid collateral in reserve for payment defaults helps alleviate risk.

- Banks are less responsive to the balance of loan form of guarantee; fewer loans are funded by banks under this type of guarantee.

- Payment guarantees require more administrative support, particularly with a deteriorating loan portfolio, and require more alert management.

20

SECTION III

LEGAL AND ACCOUNTING CONSIDERATIONS

SECTION III
LEGAL AND ACCOUNTING CONSIDERATIONS

A. Legal Considerations

This consultancy has requested outside counsel to advise on legal matters concerning the guarantees issued by the Czech Fund. To accomplish this, it is first necessary to understand Czech law as it applies to guarantees. The enabling legislation that grants authority to the Minister of the Environment for the issuance of guarantees also needs to be reviewed. Are there limits on the minister's powers to grant guarantees as to amount and term, or are the powers without limitations? Counsel had not yet completed work in this area as of the date of this report. In the event this guarantee consultancy is expanded, additional legal considerations will be explored.

B. Accounting Considerations

Several accounting issues concerning the guarantee need to be considered.

Disclosure of commitments. The Czech Fund should disclose in the footnotes of its published financial statements its total exposure to the contingent liability created by the guarantees. Guarantees should be broken down by size of project, type (air, water, soil, waste, nature protection), geographic location, issuance date, and date of expiration. There should be a reference to the amount of reserve that has been provided for potential losses in the future.

Risk rating and provision for future losses. It is recommended that the Fund establish a credit risk rating of each guarantee. These individual risk ratings should then be used as the basis for creating loss reserve calculations. The risk rating methodology should be "prudent" and acceptable according to international accounting standards. The Czech National Bank has promulgated standards for commercial banks that could be suitable for the Fund.

Guarantee issuance fees. In the event the Fund receives fees from the project applicant for the issuance of a guarantee to a lender, that fee should be recognized as income over the period of the loan. If the amount were immaterial, the Fund might recognize the fee income in the current accounting period as a recovery of expenses related to credit management work. This issue should be settled by the Fund's accountants.

Control system. It is essential that the Fund have a control system to ensure that all issued guarantees are recorded. The system should allow easy access to the Fund's legal, accounting, and credit staff for ongoing monitoring of the guarantees. Each time a new guarantee is issued, all relevant areas of the Fund should be alerted to the commitment.

SECTION IV

RECENTLY AUTHORIZED LOAN GUARANTEES

SECTION IV
RECENTLY AUTHORIZED LOAN GUARANTEES

A. Background

While a sound, thoughtfully designed program of loan guarantees could assist the Ministry of the Environment in advancing its objectives, the six guarantees approved recently pose serious risks. They should be carefully evaluated by senior policy makers and implemented only if the risks can be controlled. A failure of these particular guarantees could jeopardize consideration of the more significant, and potentially quite valuable, programmatic approach to guarantees.

B. Risks and Concerns

Guarantee arrangements pose a number of risks to the Czech Fund.

Insufficient definition. The resolutions do not specify in sufficient detail the Fund's intentions or obligations, nor do they define the roles of potential participating financial institutions or their borrowers. Although the Fund's guarantee policy is a positive step toward defining its role in providing guarantees, it does not contain details necessary to protect its interests or define its financing role to the banks. (See an assessment of the Fund's guarantee policy in Section IV.C and the recommended components of a guarantee policy in Section I.C.) As a result of this limited definition, the banks and the borrowers request and establish the significant terms of the guarantee. These terms are unquestionably to the advantage of the bank and the borrower and may contribute to unnecessary and unintended long-term credit exposure to the Fund.

Inefficient allocation of project risk and Fund resources. The Fund's proposed guarantees, which in some cases could be interpreted as full unconditional guarantees or construction/completion guarantees, may inefficiently allocate its resources and entail an unnecessarily high level of support. The characteristics of and participants in the projects should shape the form and substance of the Fund's guarantee. The guarantee should not place the Fund unnecessarily at risk but should work with guarantees from the other project participants to allocate credit support and disperse risk. Unfortunately, the Fund requires and receives only limited financial information about the projects, the borrowers, the financing scheme, or the project participants.

Concentrated credit exposure. Given the size of the projects, any defaults by the borrowers under a guarantee would pose a critical threat to the Fund's financial condition. Most guarantees are much larger credit exposures than any of the loans the Fund currently makes, and unlike existing Fund loans, they create a contingent liability that must be funded. A single default of a large guarantee could undermine the revenue available for other programs and projects the Fund supports. (One pending guarantee for Kc710 million exceeds the entire projected 1996 loan repayments.)

Long-term commitment of Fund resources. The seven guarantees (six proposed and one funded) commit substantial funds to the Czech Fund. As a result, current and future revenues must be used to cover a loss reserve for a small number of projects. The potential direct credit exposure of the seven guarantees is Kc1.17 billion, nearly twice the anticipated 1996 loan repayments of Kc622 million and 30 percent of the Fund's projected 1996 revenue (excluding the nonrecurring transfers from the National Property Fund for the Air Protection Program). In at least one case, the commitment is for 15 years.

Inadequate evaluation of risk. For the Fund to finance adequately a loss reserve for the contingent liabilities of guarantees, it must evaluate, measure, monitor, and manage the credit risk of its guarantees. The Fund should evaluate the risk before a guarantee commitment is made and again during the life of the guarantee. Adequate funding of a reserve is critical in establishing financial institutions' reliance on the guarantees the Fund provides. The proposed guarantees involving complex projects requiring substantial Fund scrutiny are risky because they involve high capital investments, new ownership and/or operating entities, low equity contributions (highly leveraged transactions with high debt to equity ratios), high risks during construction and start-up phases, a specialized market for the products and services produced, and a number of participants and beneficiaries (owners and investors, construction firms and vendors, plant operators, customers or service users, financial institutions, and the local, regional, and national government). On the other hand, the number of participants can be a potential benefit to the projects.

Incentives for borrower default. The Dobra Voda guarantee is an installment payment guarantee that requires the Fund to pay those installments not made by the borrower under the loan agreement with the bank. Two quarterly installments have been paid by the Fund after the company failed to make its loan payments. The interest rate on the bank loan is 12 percent and the interest rate on the Fund loan made to the company for the defaulted installment payments is 5 percent. Under this guarantee agreement, the company has no disincentives, such as commensurate or higher interest rates or penalty fees, to meet its obligation with the lender. Further, the Fund did not have a collateral agreement with the company and was forced to negotiate and establish this after the loan defaulted.

Unspecified triggers for default. The trigger mechanism for default under a guarantee must be precisely stated and easily executed. The Fund is potentially involved in issuing two substantial forms of payment guarantees. One covers facility construction and testing. The other is a payment guarantee covering the term-loan payment period, which may run for several years. The guarantees highlight the risk that the Fund takes in guaranteeing the construction and testing of a project such as a waste incinerator. The Fund's risk in these guarantees can be open-ended, having no time or even cost limit. If the incinerator is not completed on time or has imperfections that prevent operation in accordance with required specifications, the long-term lender will not take out the short-term lender, who will call the Fund guarantee. The Fund, forced to pay the bank's demand, then must decide whether to complete the project at additional cost or abandon it. The latter decision bears not only a financial cost but, more important, carries an environmental cost and exposes the Fund to public criticism.

C. Review of Czech Fund Guarantee Policy and Documentary Procedures

C1. Current Policy on Guarantees

A Fund management memorandum dated February 1996 (see Annex A) is the extent of the policy currently used to guide the Fund in issuing guarantees. The memorandum is a good start on a guarantee policy, but the policy should elaborate on how best to serve the Fund's environmental, technical, and financial interests. The following are the issues covered in the memorandum, each accompanied by an assessment of its weaknesses.

25

- Guarantees are to be approached in the same manner and with the same approval process as a direct loan. Technical and financial analysis must precede the ministerial order of a guarantee. *The existing guarantee resolutions did not follow this policy; the former Minister of the Environment issued guarantee resolutions without advance technical and financial review.*

- Guarantees are designed only for separate installments of principal and interest. These guarantees will not apply to interest penalties charged by the bank for violations of loan agreements. *There is no mention of the obligation to pay the creditor's legal and collection expenses or other administrative expenses a creditor may incur as part of its loan collection effort.*

- Debtors will agree to reimburse the Fund for payments made to the banks under the guarantee. *No specific definitions are made on this fundamental matter of policy.*

- Collateral selection will be derived from the solvency of the client. *There is no further clarification.*

- Loss reserves will be calculated annually based on 20 percent of the amount of installment payments due to the creditor banks in the following year. The reserve will be adjusted quarterly to reflect payment reductions. *The policy does not reflect specific credit risks per project.*

- Guarantees are available for Czech debtors who have arranged financing through foreign credit sources. These types of arrangements will be limited due to foreign exchange risk. *No specifics are offered on the amount of the limits.*

C2. Current Procedures of Issuing Guarantees

The Fund has no written procedures for the administration of a guarantee program. The following procedures reflect existing practices:

1. The Minister of the Environment entertains a request for a guarantee from a prospective debtor. He issues a resolution listing the name of the project applicant (investor), the amount to be guaranteed, location of the project, and information on the nature of the project. General and sometimes specific conditions may be attached to the resolution (see Annex C for copies of the resolutions).

2. With the guarantee, the investor then seeks financing.

3. The creditor bank notifies the Fund of its loan. The Fund then determines what documentation is to be prepared. Because only the 1992 Dobra Voda transaction has developed to the financing stage, the next steps can only be speculated, although they would most likely be dictated by the lender. Most likely, collateral will be requested to support the guarantee (though no collateral was taken for the Dobra Voda guarantee) based upon the Fund's current loan guidelines. The collateral agreement will most likely be prepared by the Fund's legal unit to verify that the collateral agreement is in compliance with the civil code and legal requirements for collateral.

SECTION V

SUMMARY AND RECOMMENDATIONS

SECTION V
SUMMARY AND RECOMMENDATIONS

The adoption of a well-conceived program of loan guarantees would represent a positive development for the Czech environment and for the institutions financing environmental investments. On the other hand, at least some of the several guarantees recently authorized present risks that in all likelihood outweigh their benefits.

The primary objective in establishing a guarantee program should be to deliver a guarantee product that stimulates additional funding for environmental projects, that forges a collaborative relationship between the Czech Fund and commercial lenders, and that balances the incentive of subsidies with the healthy discipline of commercial prudence. The Ministry of the Environment and the Fund might proceed as follows:

- Conduct a wide-ranging discussion among senior policy makers on the advantages and risks of loan guarantees. Draw into the discussion the Ministry of Finance, the Agricultural Department Guarantee Program, commercial bankers, and municipal officials, along with the Ministry of the Environment and the Fund.

- Study and model the financial consequences of loan guarantees on the lenders, the Fund, and the municipal and business borrowers.

- Explore successful guarantee programs in the Czech Republic and in Poland, Germany, and the United States.

- Structure a program of guarantees that not only takes into account the environmental and financial market objectives but also conforms Czech regulation.

- Draft policies and procedures for the Fund and the Ministry of the Environment.

- Select partner financial institutions, presumably on a competitive basis, and enter appropriate agreements.

Recommendations with respect to the six guarantees recently authorized by the Ministry of the Environment are as follows:

- Subject the projects to detailed environmental, legal, and financial analysis. Engage an experienced banker to lead this effort.

- Implement only those guarantees that are sound and prudent. Consider other forms of assistance to those that are unsound.

- Refrain from making additional guarantee resolutions or commitments until policies, procedures, and controls have been established.

ANNEX A

RECENTLY AUTHORIZED LOAN GUARANTEES

ANNEX A
RECENTLY AUTHORIZED LOAN GUARANTEES

Company	Industry	Project Cost/ Guarantee (millions Kc)	Type of Guarantee
Dobra Voda HBSW	Consumer bottled water	Project cost unavailable/400	Installments for term of loan (Loan was made in 1992)
Stredisko likvidace odpadu Oslavany a.s.	Industrial incineration	2,236/200	Unspecified
ECO GAIA a.s.	Industrial incineration	710/710	Installments for 15 years
SJUKO s.r.o.	Hydroelectric	25.1/17.5	Installments during construction and testing
Povodi Vltavy a.s.	Hydroelectric	163/163	Installments during construction and testing
CATRIN market s.r.o.	Manufacturer of filling materials	35/33.5	Installments for seven years; then balance of loan
Ekochab s.r.o.	Natural gas production	70.3 / 40.2	Installments for term of loan

NOTE: Of the above guarantees, only Dobra Voda has been financed. The remaining were provided resolutions by the Minister of the Environment between October 1995 and April 1996 but have not obtained financing.

ANNEX B

THE CZECH FUND'S CURRENT GUARANTEE POLICY

ANNEX B
THE CZECH FUND'S CURRENT GUARANTEE POLICY (TRANSLATION)

SFZP
Czech Republic

Prague, February 1, 1996

Background material for meeting of SFZP's management

Subject: Approach of SFZP to providing guarantees

Reason for submitting the material:
Task from PV No. 1/33/95

Proposal of ruling:
1. The management approves the submitted material
2. The management imposes a duty to submit this material for a discussion to the board of the Fund

Submitted by: Ing. Jaroslav Nevyjel
Financial Director

Approach of SFZP CR to providing guarantees

Providing guarantees, according to appendixes of Guidelines for 1996, is one of the basic forms of assistance. Before a draft of decision is worked out, a project is evaluated from the technical point of view, that means from the point of view of environmental contribution, from the point of view of client's ability to pay, etc. The procedure is the same as if the client had asked for a loan. The guarantee can be provided only after it is discussed by the Board of the Fund and signed by the Minister of the Environment. Based on the decision of the Minister, the fund and the client conclude an agreement on future agreement, and a guarantee statement is issued for the bank involved.

The Fund guarantees only separate installments and the interest rate. It does not provide guarantee for sanctions (sanction interest rates) related to violations of the credit agreement. Single payment of the loan with the bank is also inadmissible from the point of view of violating the credit agreements.

With regard to the special form of assistance, it is necessary to observe all acts dealing with state funds. That means that if a guarantee is provided, selection of a supplier (a bank?) in accordance with Act No. 199/94 will be required.

Agreement on future agreement is concluded between a client and SFZP because the client is obliged by conditions of returnability of financial funds in case the guarantee has to be returned to the bank.

Claims on the client will be evaluated in the following way:

1. If the goals of the project that was granted a guarantee are not met (i.e., relevant construction is not realized or there is no environmental contribution, etc.) The Fund will <u>require immediate return of its funds</u>. If the funds are not returned according to agreed conditions, they will be claimed by court ruling. The amount of money will bear an interest rate equal to the interest rate of the bank credit. Violation of agreed contractual conditions will be sanctioned according to internal regulations of the Fund.

2. If the relevant construction is built and goals of environmental contribution are met, the client and the Fund will negotiate a part payment schedule. This possibility represents a solution to a case when the client has financial problems and cannot pay an installment to the bank within a given period. To avoid client speculation, the fund will use the same interest rate as the bank credit.

<u>The form of claim collateral will be chosen individually according to solvency of the client</u>. Where real estate is used as collateral, it is necessary to conclude a lien agreement. Procedures for dealing with the lien will be in accordance to relevant internal regulations of the Fund.

<u>Relevant reserves will be created for each guarantee provided by the Fund. All guarantees will be subject to proper registration</u>. The amount of reserve will be based on amounts of installments to financing banks to which the guarantee was provided. From this amount will be created reserves for the following year in the amount of 20%. (Those reserves will be specified and decreased quarterly to reflect installments already paid.)

SFZP can provide a guarantee to a native person who has credit abroad. According to foreign exchange such action is neither limited nor regulated. Such guarantees will be provided only occasionally, with respect to possible exchange rate risks.

Worked out by: Ing. Jaroslav Nevyjel in cooperation with economical, control, and legal departments.

133

ANNEX C

RESOLUTIONS FOR GUARANTEES

ANNEX C
RESOLUTIONS FOR GUARANTEES (TRANSLATION)

Prague
Ref. No.: 4117/D/96

Resolution
No. 03069641
on providing support from the State Fund for the Environment of the Czech Republic

According to §1, article 5, law No. 388/91 Coll.
on the State Fund for the Environment of the Czech Republic

I approve:	A loan guarantee in the amount of Kc42,000,00, e.g., 60% of the base for setting the support, which is Kc70,340,000
For a project:	Degassing of dump TKO Praha Dolni Chabry and production of treated natural gas/biogas/
Realized in:	1996
For an applicant:	Ekochab, s.r.o. Praha 8 Dolni Chabry, 184 00

Under the following basic conditions:

The total amount of the support set by a % share of the base for setting the support stated in this resolution is a maximum and it will be specified based on the selection of the supplier carried out in accordance with law 199/94 Coll. and concluded supplier's agreements. Potential increase of the specified budgeted costs (above the base for setting the support) is covered by the applicant from his own sources, when decreasing the base for setting the support the % share remains unchanged.

The project will be realized in accordance with the approved documentation.
- The applicant will select a supplier in accordance to law No. 199/94 Coll. on public orders.

In order to conclude a written contract between the Fund and the applicant, it is necessary to submit the documents mentioned in Appendix No. 3a of the Directive of the Ministry of the Environment of the Czech Republic on funding from the SFZP.

The loan guarantee will be provided for the annuity of the loan, until the realization of the approval decision.
- The realization of the measure will reduce the emission load of the hydrocarbons from the dump by 6,000 t/year by 2006.

Based on this resolution, the Office of the Fund and the realizator under the §5, article 3 letter f) of the Statute of the SFZP will conclude a contract which will also include other conditions for providing the support. If the contract is not concluded within five months after the date of the issuance of this resolution, the Fund has a right to withdraw from it, by which the validity of this resolution terminates.

Prague, March 27, 1996
Ref. No.: 9637/D/95

Resolution
No. 01299627
on providing support from the State Fund for the Environment of the Czech Republic

According to §1, article 5, law No. 388/91 Coll.
on the State Fund for the Environment of the Czech Republic

I approve:	A loan guarantee in the amount of Kc35,000,000, e.g., 97.7% of the base for setting the support, which is Kc35,000,000
For a project:	Realization of the production of expanding filling materials and products
Realized in:	1996
For an applicant:	CATRIN market, s.r.o., Tiskarska 10, 108 28 Praha 10-Malesice

Under the following basic conditions:

The total amount of the support set by a % share of the base for setting the support stated in this resolution is a maximum and it will be specified based on the selection of the supplier carried out in accordance with law 199/94 Coll. and concluded supplier's agreements. Potential increase of the specified budgeted costs (above the base for setting the support) is covered by the applicant from his own sources, when decreasing the base for setting the support the % share remains unchanged.

The project will be realized in accordance with the approved documentation.

In order to conclude a contract between the Fund and the applicant, the applicant will submit concluded contracts on loan and/or leasing with bodies providing other sources of financing.

The applicant will select a supplier in accordance with law No. 199/94 Coll. on public orders.

In order to conclude a written contract between the Fund and the applicant, it is necessary to submit the documents mentioned in Appendix No. 3a of the Directive of the Ministry of the Environment of the Czech Republic on funding from the SFZP.

- The production program will be primarily using otherwise non-workable waste materials and recyclates, only in case of demonstrable shortage of such materials alternative raw materials will be used.
- The guarantee of SFZP will be provided for the annuities of the loan, including interest rates for the maximum period of seven years. The time limit will be specified based on the loan contract with the financing bank.

Based on this resolution, the Office of the Fund and the realizator under the §5, article 3 letter f) of the Statute of the SFZP will conclude a contract which will also include other conditions for providing the support. If the contract is not concluded within five months after the date of the issuance of this resolution, the Fund has a right to withdraw from it, by which the validity of this resolution terminates.

36

Resolution

No. 06209527

on providing support from the State Fund for the Environment of the Czech Republic

According to §1, article 5, law No. 388/91 Coll.
on the State Fund for the Environment of the Czech Republic

I approve:	A loan guarantee in the amount of Kc163,000,000 (100% of the base) (the base for setting the support is Kc163,000,000)
For a project:	Hydroelectric power plant Libcice-Dolany
Realized in:	1995-1997
For an applicant:	Povodi Vltavy a.s., Holeckova 8, Prague 5

Under the following conditions:

The total amount of the support set by a % share of the base for setting the support stated in this resolution is a maximum and it will be specified based on the selection of the supplier carried out in accordance with law 199/94 Coll. and concluded supplier's agreements. Potential increase of the specified budgeted costs (above the base for setting the support) is covered by the applicant from his own sources, when decreasing the base for setting the support the % share remains unchanged.

The project will be realized in accordance with the approved documentation.

- The applicant will select a supplier in accordance to law No. 199/94 Coll. on public orders.

In order to conclude a written contract between the Fund and the applicant it is necessary to submit the documents mentioned in Appendix No. 3a of the Directive.

The loan guarantee will be provided up to the amount of the annuity of the loan, until the test operation, when the investor undertakes all the obligations given in the loan and collateral contracts.

Based on this resolution, the Office of the Fund and the realizator under the §5, article 3 letter f) of the Statute of the SFZP will conclude a contract which will also include other conditions for providing the support. If the contract is not concluded within five months after the date of the issuance of this resolution, the Fund has a right to withdraw from it, by which the validity of this resolution terminates.

Prague, December 13, 1996
Ref. No.: 6886/D/94

Resolution
No. 08689427
on providing support from the State Fund for the Environment of the Czech Republic

According to §1, article 5, law No. 388/91 Coll.
on the State Fund for the Environment of the Czech Republic

I approve:	A loan guarantee in the amount of Kc17,500,000 (69.7% of the base) (the base for setting the support is Kc25,113,000)
For a project:	Weir Troubky-R.Smolka, MVE, weir of the river Becva
Realized in:	1993-1996
For an applicant:	SJUKO s.r.o., Fugnerova 7, Prerov 750 02

Under the following basic conditions:

The total amount of the support set by a % share of the base for setting the support stated in this resolution is a maximum and it will be specified based on the selection of the supplier carried out in accordance with law 199/94 Coll. and concluded supplier's agreements. Potential increase of the specified budgeted costs (above the base for setting the support) is covered by the applicant from his own sources, when decreasing the base for setting the support the % share remains unchanged.

The project will be realized in accordance with the approved documentation.

- The applicant will select a supplier in accordance with law No. 199/94 Coll. on public orders.

The applicant will meet the conditions stated in the Resolution on permit to deal with waters and to build water supply related works issued by the region authority in Prerov, department of the environment, dated January 2, 1995, under the Ref. No. ZP/Vod.6000/94-235/1-R-Hk.

Prior to signing a contract with the Fund, the applicant will submit a loan agreement with the financing bank.

SFZP will provide a loan guarantee only during the time of construction until the test operation starts, when the investor undertakes all the obligations given by the loan agreement.

Based on this resolution,the Office of the Fund and the realizator under the §5, article 3 letter f) of the Statute of the SFZP will conclude a contract which will also include other conditions for providing the support. If the contract is not concluded within five months after the date of the issuance of this resolution, the Fund has a right to withdraw from it, by which the validity of this resolution terminates.

38

Prague, December 7, 1995
Ref. No. 8145/D/95

Resolution
No. 03929541
on providing support from the State Fund for the Environment of the Czech Republic

According to §1, article 5, law No. 388/91 Coll.
on the State Fund for the Environment of the Czech Republic

I approve:	A loan guarantee in the amount of Kc710,000,000 (100% of the base) (the base for setting the support is Kc710,000,000)
For a project:	Construction of ECO BLOCK GAIA - objects for thermal industrial waste disposal
Realized in:	1993-1997
For an applicant:	ECO GAIA a.s., Ptacka 30/IV, 239 01 Mlada Boleslav

Under the following basic conditions:

The collateral will be provided for the annuities of the loan provided by a contractual bank. After completion of the construction, the collateral obligations will be passed onto the investor.

- The amount of the loan will be specified by the applicant no later than the conclusion of the contract with the Fund by submitting a specific loan contract with the financing bank in which the amount of interest rate and term of the loan will be specified.
- The level of the support is set at its maximum and the condition for providing it is to carry out a tender in accordance with law No. 199/94 Coll. and to conclude respective contractual agreements.
- Potential increase of the specified budgeted costs (above the base for setting the support) is covered by the applicant from his own sources, when decreasing the base for setting the support the % share remains unchanged.

The project will be realized in accordance with the approved documentation.

While operating the installed equipment, the emission limits will be met in accordance with the regulation of the Federal Committee for the Environment dated June 23, 1992, which amends the regulation of the Federal Committee for the Environment dated October 1, 1991, of law No. 309/91 Coll. on the protection against pollutants.

In order to conclude a written contract between the Fund and the applicant, it is necessary to submit the documents mentioned in Appendix No. 3a of the Directive.

Based on this resolution, the Office of the Fund and the realizator under the §5, article 3 letter f) of the Statute of the SFZP will conclude a contract which will also include other conditions for providing the support. If the contract is not concluded within five months after the date of the issuance of this resolution, the Fund has a right to withdraw from it, by which the validity of this resolution terminates.

Prague, October 19, 1995
Ref. No. 1995 D 95

Resolution

No. 00699541

on providing support from the State Fund for the Environment of the Czech Republic

According to §1, article 5, law No. 388/91 Coll.
on the State Fund for the Environment of the Czech Republic

I approve:	A loan guarantee in the amount of Kc200,000,000 (the base for setting the support is Kc2,236,000,000)
For a project:	Incinerating plant for industrial waste Oslavany
Realized in:	1994-1997
For an applicant:	Stredisko likvideace odpadu Oslavany a.s., Nadrazni 9

Under the following basic conditions:

The total amount of the support set by a % share of the base for setting the support stated in this resolution is a maximum and it will be specified based on the selection of the supplier carried out in accordance with law 199/94 Coll. and concluded supplier's agreements. Potential increase of the specified budgeted costs (above the base for setting the support) is covered by the applicant from his own sources, when decreasing the base for setting the support the % share remains unchanged.

The project will be realized in accordance with the approved documentation and in accordance with legal regulations on the waste disposal industry: law No. 17/92 Coll. on the environment, law No. 238/91 Coll. on waste, law 309/91 Coll. on the protection of the environment, and the resolution of the Government of the Czech Republic No. 513/92 Coll. on details of waste disposal.

While operating the installed equipment, the emission limits will be met in accordance with the regulation of the Federal Committee for the Environment dated June 23, 1992, which amends the regulation of the Federal Committee for the Environment dated October 1, 1991, of law No. 309/91 Coll. on the protection against pollutants.

The applicant will select a supplier in accordance with law 199/94 Coll. on public orders.

40

ANNEX D

INTERVIEW LIST

ANNEX D
INTERVIEW LIST

Joseph Snopek, Loan Porfolio Administration Department, Komercni Banka
Jana Benesova, Komercni Banka
Helena Effenbergerova, Komercni Banka

Peter Knapp, Board member, Head of Credit Division, CSOB
Vera Bruhova, CSOB
Ales Kraus, Credit Policy Department, CSOB

Ladislav Valesek, Bank Specialist, Ernst and Young
T.J. Alston, Senior Partner Audit, Ernst and Young

Lubomir Rajdl, Director, Czech-Moravian Guarantee and Development Bank

Jaroslav Nevyjel, Financial Director, Czech State Fund for the Environment (SFZP)
Milos Rybicka, Chief of Credit Policy, SFZP
Jiri Borecky, Chief of Credit Analysis, SFZP
Frantisek Zelenka, Interior Relations Department, SFZP

Marie Cihelnova, Economist, Agriculture Ministry
Jitka Vlckova, Head of Section, Agriculture and Forestry Support and Guarantee Fund (PGRLF)

Miroslav Hajek, Assistant Section Head Agriculture and Environment, Ministry of Finance
Vladimir Kulhanek, Deputy Director, Agriculture and Environment Section, Ministry of Finance

ANNEX E

GLOSSARY OF TERMS

ANNEX E
GLOSSARY OF TERMS

The glossary is being prepared in Czech for the benefit of the Czech readers.

ANNEX F

CAPITAL ADEQUACY OF BANKS

ANNEX F
CAPITAL ADEQUACY OF BANKS

Excerpts from the Provision on Capital Adequacy of Banks of the Czech National Bank, October 5, 1995.

Summary: The Czech National Bank rates claims of commercial banks (guarantees) on the Czech State Fund for the Environment (SFZB) at zero for calculating banks' capital/risk-weighted assets ratios, which is equal to the risk rating for the state government. The Fund's guarantee must meet five conditions (see below) to satisfy the zero rating. The zero rating implies that the credit market, particularly foreign and domestic commercial lenders, will view the Fund's guarantee as Czech sovereign risk.

Background and excerpts from the provision:

Article 4
Risk-weighted assets are all assets of the bank multiplied by the respective risk weight according to the credit risk rate of each type of asset.

Article 6
(from the table of zero risk weights, page 6)
"claims on agencies sponsored by the Czech Republic government . . . ." are zero rated.

Article 7
(1) In cases when a claim or potential claim is secured by a) a guarantee or bank guarantee, including bill of exchange aval (hereinafter "guarantee"), it can be assigned a risk weight corresponding to the guarantor provided

1. the guarantee is in a written form,
2. the guarantee is irrevocable,
3. the only condition for exercising the right to the guarantee is the debtor's failure to meet his commitments toward the bank,
4. the guarantee is unambiguous,
5. the guarantee is issued so as not to allow the guarantor or any other person to curtail in any way the legal claims of the bank following from the guarantee.

Appendix 2 (explanation of some terms used in the provision)
¶ 10. Government Sponsored Agency means any agency, established or hired by a government to serve public purposes, whose commitments are not unconditionally, explicitly, and unlimitedly secured by the central government. For the purposes of this Provision, a Government sponsored agency means:

State Fund for the Environment (included within a list of several agencies)

The Czech National Bank gives a zero risk weight to obligations of SFZB