Contingent Liabilities: the Governance Framework

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Outline

- Some Recent Trends – Fiscal Risks and CLs
- The Role of the Debt Manager
- Institutional Arrangements

Some Trends

East Asian financial crisis drew attention to CL exposures – Indonesia's GDP fell by 35%

Over last 25 years governments experienced on average an adverse fiscal shock of 6% of GDP every 12 years – many finance related

DMUs have responded – often the only source of expertise – but focus on guarantees and on-lending, linked with loans and credits

But expanding sources of risk and awareness of implications (inc for fiscal policy) => development of IMF Fiscal Risk Management Framework

The Fiscal Risks Matrix

Contingent Liability	Identify and Quantify	Mitigate			Provision		
		Direct Controls	Indirect Tools (regulation and fees)	Risk Transfer Instruments	Expense	Contingencies	Buffer Funds
Financial Sector	Quantify contingent exposures (e.g., CCA) Monitor financial soundness and risk indicators (early warning systems) Incorporate financial stress tests into DSA	Reduce state participation in the financial sector	Increase sector's loss absorbing capacity Utilize macroprudential tools to reduce procyclicality Reduce debt bias in tax system	Require banks to fund deposit insurance schemes Resolution mechanisms (e.g., living wills)	Appropriate expected payments	Maintain cash buffers	Pre-fund deposit guarantee schemes
Natural Disasters	Early warning systems	Reduce footprint in risky areas	Tax premia in high risk areas Environmental standards Building codes Disaster preparedness strategies	Reinsurance Catastrophe bonds Limit payouts and require deductibles for govt schemes Mandate insurance in high risk areas	Appropriate expected payments	Disaster contingency	Natural disaster funds
Guarantees	Maintain a central registry of guarantees; assess risks at time of issue and over their life	Central authorizing entity Ceilings on liabilities Standard issurance criteria Conditions on access	Charge risk-related fees	Partial guarantees Require collateral Reinsure if feasible	Appropriate expected cash flows	Provision for expected calls	Guarantee funds
PPP	Maintain central registry of PPP commitments Subject projects to sensitivity analysis	Central authorizing entity Ministry of Finance gatekeeper role Ceilings on PPP commitments	Value for money checks Charge guarantee fees	Risk sharing framework Limit payments linked to demand Insure retained contract risks where feasible	Appropriate expected cash flows	Provision for expected calls	Guarantee funds
SOEs	Quantify explicit exposures Monitor financial performance Scenario analysis and stress testing	Reduce size of the SOE sector	Hold boards accountable for performance Reporting requirements	Explicit no-bail out clauses	Appropriate expected subsidies and quasi fiscal activities	Provision for cost in case of restructuring	
Subnational Government	Monitor financial performance against benchmarks	Fiscal rules and limits on borrowing	Link degree of financial autonomy to performance Reporting requirements	Establish credible no-bail out clauses Retain authority to liquidate assets / appoint administrator	Appropriate expected support		Rainy day funds

Source: IMF 2016

In Practice……

- IMF recommended central Fiscal Risk Units
  - Identifying, assessing, monitoring and reporting risks
  - Mitigation techniques; establishing targets
  - Buffers in fiscal path
- But FRUs are not well established outside some AEs

- DMU may still be only unit in government with developed risk management skills
- Debt manager retains
  - Lead responsibility for explicit CLs whose crystallisation directly adds to debt
  - An overview of the government’s balance sheet
- CL analysis must be integrated into debt management strategy (DMS)

The Role of the Debt Manager Today

- Contribute to general CL policy (with [Fiscal Risk Unit])
  - Design general CL policy, including guidance on analytical methodologies
  - Establish borrowing guidelines for public sector beneficiaries of guarantees on debt
  - Develop methodologies to identify and measure risks (inc to assess PPPs)
  - [Potentially] propose ceiling on guarantees for budget
- Assist [Fiscal Risk Unit] with budgeting
  - Centralising data; establishing methodology for CL cost estimation and pricing; identifying budget provisions & buffers
- Implement Risk Management – the Main Task!

Tools of Analysis, Measurement & Mitigation

Defining Characteristics	• Characteristics of Guarantee Portfolio • Clear Definition of Risk Exposure • Data availability • Resources and capacity
Risk Analysis	• Analysing key risk factors of guaranteed entity using various methodologies • A Credit scoring; B Statistical models; C Scenario analysis; D Structural models
Risk Quantification	• Various target measures, e.g. Expected loss, Market value, Unexpected loss, Maximum exposure. • Primary approaches: Price differentials and Bottom up: estimation of default probabilities
Risk Management and Risk Tools	• Structuring of guarantees, inc risk sharing; • Setting limits, fixing fees; Provisioning for losses; Managing risk funds; • Reporting on and monitoring risks

Based on: Bachmair 2016

Complications of PPPs

Scope for substantial benefit if risk transfer drives value for money

But extra challenges

- Ministers often see PPPs as a Free Lunch
- Financing structures are opaque
- Difficult to identify risks over a long period (up to 30 years)
- Not covered by legislation designed for guarantees

Often handled by a separate unit in MoF

- Requires different skills (contractual, corporate finance)
- Insist that DMU is able to comment, e.g. on implied cost of capital?

Some PPPs have more explicit debt-like qualities

- If government has guaranteed a regular purchase, e.g. of electricity from a build-own-operate supplier, some part will be remunerating the supplier's capital investment
- Not very different from interest on the bond that the government might have issued had it itself constructed the plant – must take into account in DMS

CLs and the DMS

- Interaction between debt structures and economic shocks
  - Compare the CL shock in the DSA
  - Even if central government has reduced its FX liabilities, it might still be exposed to an exchange rate depreciation if SOEs are heavy external borrowers
- How will be balance sheet as a whole be affected by different shocks – central to ALM analysis
  - Exchange rate and interest rate shocks affect values of financial assets, liabilities and net worth
  - Implications for future borrowing costs
  - Impacts on discounted revenue and expenditure flows
- Scope for hedging residual risk
  - Catastrophe bonds, loss sharing, loss provisions, collateral

Strengthening Institutional Arrangements

Who has approval powers

- Parliament – open to the same problems as approval of individual debt transactions – should approve programme and policy only
- Minister/Cabinet - requires some high-level machinery (compare Public Debt Committee); must approve guidance, and major or unusual projects
- Head of DMO/FRU - on basis of delegated authority within agreed parameter
- <u>But must not take accountability for project delivery aware from sponsor minister or agency</u>

Disclosure requirements in legislation

Building resources, skills, capabilities

Setting Target and Ceilings – next slide

Targets and Ceilings

- Increasing use of targets
  - Whether on flows or stocks
  - Linked with debt management or budget analysis
- Conditionality on public debt in IMF arrangements is established as a limit on "public debt and publicly guaranteed debt"
  - Subject to country circumstances
  - May exclude debt of SoEs that are able to borrow without a guarantee or that pose limited fiscal risk
- Should target be of risk-adjusted exposure, not maximum exposure?
- Time dimension
  - Identify probabilities of staying below ceiling taking account of range of shocks and average response of fiscal policy to those shocks
  - Implications for buffers

Who Does What in the DMU

Front Office

- Reviewing proposals,* recommendations
- Links with assessment of loans & credits
- Agree legal documentation
- Identifying cost of capital in PPPs

Middle Office

- Developing policy, establishing guidance
- Integration with debt management strategy
- MoUs with MDAs, ,macro-fiscal unit etc

Back Office

- Collecting fees
- Monitoring exposure, early warning
- Data and reporting

*** Initial analysis should be done elsewhere**

- **in SoE, line ministry or dedicated MoF unit**

Legislation: Some Requirements parallel those in a Debt Management Law

- State has authority to accept CLs
  - Maybe in Constitution or other Statutes (eg related to deposit insurance schemes, pensions, etc)
  - For whom (private as well as public sector)?
    - Covering SoEs, PPPs, Sub-National Government…
  - Which types of obligation – guarantees or others
  - Implicit liabilities – care of moral hazard
  - Some countries allow CB to provide guarantees on Gov's behalf (Ghana)
- Decision making: Parliament, Cabinet, Minister, Hd/DMO…
- Borrowing powers include ability to meet cost of called guarantees
- Setting quantitative limits – on flows or stocks
- Reporting and auditing requirements

Some Requirements may be less familiar…

- Powers may be needed
  - To meet cost of called guarantees etc from budget
  - To raise charges/fees for the guarantee
  - To clarify how to use/invest the fees
    - In a fund (notional or real)
    - Or through the budget
    - Managed by whom
  - To recover payments from the beneficiary
- The government must have power to scrutinise
  - Responsibility of minister to ensure skills, resources, and controls are all in place to manage risks
  - Secondary legislation to require a proper risk assessment
- Must be consistent with wider PFM legal framework

Thank You!

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