



Contingent Liabilities and Risk Assessment

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Outline

- Explicit and implicit contingent liabilities
- Risk assessment and mitigating measures
- Governance, and role of the DMO
- Disclosure
- DeMPA and contingent liabilities

Explicit and Implicit Contingent Liabilities

What do we mean by contingent liabilities?

- Contingent liabilities are obligations that arise from a particular, discrete event(s) that may or may not occur.
- Contingent liabilities can be explicit or implicit

Explicit and implicit contingent liabilities

Form	Examples
Explicit: Legal obligation!	<ul style="list-style-type: none">- Guarantees and indemnities- Deposit insurance and other government insurance schemes- Uncalled capital
Implicit: Moral or political obligation	<ul style="list-style-type: none">- Liabilities of sub-national governments, social security funds, SOEs, commercial banks, big investment banks, strategically important private firms- Natural disasters

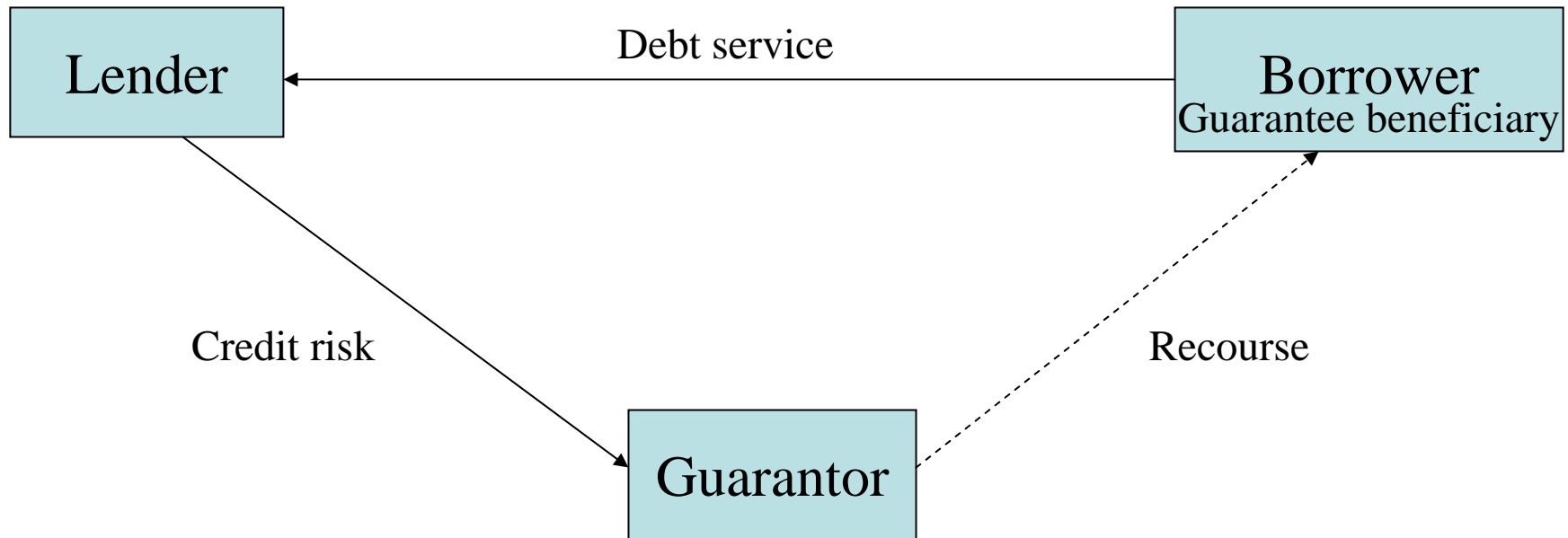
Why explicit contingent liabilities?

- The market is not prepared to insure/finance a project on reasonable terms and conditions without government support
 - Large-scale projects that require long-term insurance/financing, involve appreciable political risks, and are difficult for the market to assess due to its lack of history or unique character
- Convenient political tool: No immediate effect on the budget; leave the eventualities for the future
- Might also be used as a hidden state aid

Guarantees are the most common explicit contingent liabilities

- Loan guarantees
 - Government guarantees debt service of the beneficiary (the borrower)
- Minimum revenue guarantees (MRG)
 - Government guarantees a certain minimum revenue flow from a project (common in PPPs)
- Balance sheet guarantees
 - Government guarantees that the equity capital of the beneficiary remains at a certain minimum level

Loan guarantee



Note the similarity to a put option: The lender has the option to sell the guaranteed debt to the guarantor at an agreed-upon price (= the face value of the loan) if the borrower defaults.

Risk Assessment and Mitigating Measures

Risk assessment of explicit contingent liabilities

- Two assessments are needed: Probability of the trigger event, and the expected loss in case of the trigger
- Different models are used
 - Traditional balance sheet and business risk analysis, and qualitative assessments
 - Relative pricing: Stand-alone ratings, and estimation of the implicit guarantee value (has been used by Sweden)
 - Risk-sharing with the market: How does the market price the risk?
 - Option models: In general, however, difficult to observe market data on volatility and asset value (has been used by Chile to risk assess its exchange rate guarantees)
 - Simulation models: Time-consuming and expensive (Chile has used Monte Carlo simulation to risk assess its MRGs)

Risk assessment: 3 general rules

- Risk should be assessed before the decision to enter into a contingent liability
- Better with a rough estimate than no estimate at all; risk assessments increase risk awareness
- Risk analysis and monitoring should be separate from risk taking (e.g., an autonomous DMO, as opposed to the budget or the PPP office)

Risk mitigating measures: Explicit contingent liabilities

- Take collateral, counter-guarantees and other forms of securities
- Assure that guaranteed loans are used for the supported project, and the project is adequately insured
- Assure that the contract terms protect the government in its role as final risk taker
- Ask for revenue sharing agreement in case of MRGs
- Manage the outstanding contingent liabilities in an active manner; monitor the supported project/beneficiary
- Ask the private sector to share the risk

Risk mitigating measures: Implicit contingent liabilities

- Regulate the activities of sub-nationals, SOEs and commercial banks
- Strengthen supervision and external audit of these institutions
- Privatize SOEs
- Encourage development of markets for catastrophe bonds
- Strengthen land use regulations and building codes in areas vulnerable to natural disasters

Governance, and Role of the DMO

Who should assess and monitor the risks?

- Key requisites of the CL entity:
 - Keep updated and comprehensive records of the contingent liabilities
 - Frequently and independently assess the risks, both the probability of a trigger event and the loss/budget impact in case of a trigger
 - Continuously monitor the risks
 - Recommend risk mitigating measures

Explicit CLs: Is the DMO a candidate?

- **Loan guarantees:** Yes, contingent debt is linked to direct borrowings; assessment of credit risks and market risks have some similarities; DMOs have to consider credit risks when using derivatives, and when investing surplus cash in the market
- **MRGs related to project financing:** Yes, project financing normally is within the remit of the DMO
- **Bank deposit insurance:** Possible, this is within the financial sector; local banks are common counterparties to the DMO (primary dealers, credit lines, investment of cash surpluses)

Explicit CLs: Is the DMO a candidate? (cont'd)

- **Crop, drought and flood insurances:** No, hard to find any competitive advantages of the DMO; trigger event is the weather; risk-mitigating actions include improved seeds/plants, irrigation, etc

Implicit CLs: Is the DMO a candidate?

- **Sub-nationals and SOEs:** Yes, at least to a certain degree; DMO can very well monitor and approve the borrowings of these entities, and offer on-lending
- **The banking sector:** No, there are better candidates to assess the systemic risk (the banking regulators, and the Central Bank)
- **Strategically important private firms, and natural disasters:** No, hard to find any competitive advantages of the DMO

Implicit CLs: The moral hazard dilemma

- Risk assessment of the implicit CLs can increase the moral hazard risks
 - signal to the market that the government consider bailing out operations; why should the government otherwise assess the probability of the trigger event and budget impact?
 - expectation of a government bailout increases
 - based on this expectation banks overlend to the “beneficiary”
 - which increases both the probability of a default and the pressure on the government to intervene

Disclosure

IMF Code of Good Practices on Fiscal Transparency (2007)

“Statements describing the nature and fiscal significance of contingent liabilities should be part of the budget documentation, together with an assessment of all other major fiscal risks.” (3.1.3)

“The central government should publish information on the level and composition of its debt and financial assets, significant nondebt liabilities (including pension rights, guarantee exposure, and other contractual obligations), and natural resource assets.” (3.1.5)

“The budget documentation should report the fiscal position of subnational governments and the finances of public corporations.” (3.1.6)

IMF Manual on Fiscal Transparency (2007)

“Major contingencies should be quantified except in extreme cases where quantification is not possible.” (paragraph 192)

DeMPA and Contingent Liabilities

DeMPA is limited to loan guarantees

- There is clear authorization to issue loan guarantees, and a legal requirement to annually report on issued loan guarantees to the Parliament (DPI-1)
- Loan guarantees are prepared and issued by several entities that closely coordinate both between themselves and with the Principal DeM Entity. For the “A” score, loan guarantees must be prepared and issued by the Principal DeM Entity (DPI-2)

DeMIPA is limited to loan guarantees (cont'd)

- There are documented policies and procedures for the approval and issuance of loan guarantees (“C” score), these policies and procedures contain a requirement to assess the credit risks before the approval of any loan guarantees, as well as guidelines on how this assessment would be conducted (“B” score), and, for the “A” score, include a requirement to calculate a guarantee fee covering the credit risk, as well as a requirement for the issuance entity to monitor the risks during the life of the loan guarantee (DPI-10)
- All statutory and contractual reporting of total nonfinancial public sector loan guarantees are met (DPI-15)



Thank you!

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