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Management of explicit contingent liabilities
Credit guarantees for state-owned entities' debt

Introduction

There has been a substantial shift, over the last few years, in the structure and function of the state. This has been characterised by a transition from the direct provision of services to the facilitation of services through new fiscal tools. These tools include debt service or credit guarantees to public and private entities, programme loan guarantees and guaranteed bonds provided to banks. This has resulted in a significant increase in government exposure to explicit (legal) and implicit (circumstantial) contingent liabilities.

This governance structure results in a repositioning of credit risk (the risk of an entity's defaulting on its debt) to the government. The greatest portion of such credit risk stems from the guaranteed debt of state-owned entities (SOEs). Therefore, the proliferation of political interference within, poor management of and irresponsible borrowing practices by SOEs should be of primary concern to African governments, particularly their ministries of finance.

Recognising the role of strong institutions and well-defined risk mitigation strategies in limiting contingent liabilities, the Collaborative Africa Budget Reform Initiative (CABRI) held a policy dialogue on managing contingent liabilities in December 2016. With the technical and financial assistance of the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH, the dialogue brought together debt, risk and budget officials from Benin, Botswana, Egypt, The Gambia, Kenya, Mali, Mauritius, South Africa, Tunisia, Uganda, Zambia, Zimbabwe and Turkey. The common challenge to debt and fiscal sustainability facing these countries is the credit risk posed by guarantees for SOEs' debt. This was the primary focus of discussions at the policy dialogue and directs the contents of this position paper.

The key challenges identified by country representatives were:

- the existence of inappropriate institutional arrangements; and
- ineffective risk analysis, measurement and disclosure.

It was noted that these challenges persist, despite proactive management of the contingent risk associated with SOEs and the support of a robust legal framework. The deliberations of the dialogue, therefore, covered five central themes: (i) the role of robust regulatory frameworks that guide the management of contingent liabilities; (ii) the role of a debt office in strengthening contingent liability management; (iii) the importance of credit risk assessments in proactively managing contingent liabilities; (iv) the importance of measurement for timely identification and mitigation of fiscal risk arising from contingent liabilities; and (v) the importance of adequate disclosure and auditing of guarantee to SOEs in increasing fiscal credibility.

A robust regulatory framework guides the management of contingent liabilities

A legal framework for the management of public debt needs to make specific provision for contingent liabilities, particularly in the form of guarantees to public and private entities (see Box 1 for a related discussion on public-private partnerships). This ensures that macro-fiscal sustainability is achieved through the promotion of fiscal transparency, accountability and discipline in the management of contingent liabilities. Most participants at the dialogue stated that their countries' public debt management frameworks make provision for their governments to issue guarantees and set conditions for issuance. However, certain countries, including Tunisia, have no legal framework for public debt or contingent liabilities.[1]

A robust framework identifies the appropriate institutional arrangements for issuing, managing and monitoring guarantees, defines relevant instruments, provides a framework of governance processes (particularly for risk management activities) and describes appropriate reporting procedures. It also incorporates *ex-ante* controls over an institution's behaviour, including limits on borrowing and deficits, and the monitoring of financial soundness. It includes *ex-post* insolvency measures, which enforce hard budget constraints and clarify appropriate risk-sharing, limiting the moral hazard associated with the expectation of bailouts.

1 Theoretically, implicit contingent liabilities cannot be covered by the legal framework, as they are undefined. However, laws and regulations can be designed to prevent implicit contingent liabilities from materialising.

Box 1: Public-private partnership framework

A public-private partnership (PPP) is a contractual arrangement whereby a project's financial, technical and operational risks are shared between the public and private sectors. Despite their potential to increase efficiency in the provision of public services, debt and revenue guarantees to private partners are a significant source of fiscal risk for governments. Delegates at the dialogue noted that many PPP projects become unsustainable due to inadequate or non-existent legal frameworks (and unfamiliarity with the complex financial instruments and risk involved). The primary reason given for the failure of Zambia's PPP projects prior to 2009 is the lack of a PPP framework in this country. Many countries have implemented a legal framework governing PPPs. Country experience, however, reveals that it can be challenging to set up PPP legal frameworks consistent with a country's existing legal structures. In Tunisia and Mali, for example, passing laws on PPPs has been a socially and politically sensitive issue.

Strong PPP legal frameworks, while safeguarding against imprudent risk-taking, also strengthen the government's bargaining power and ensure that it enters negotiations with the private sector from a position of strength. In this way, the potential for the private sector to take advantage of the public sector when negotiating terms is limited, and risk is shared fairly and priced appropriately. Codified PPP frameworks also reassure credit agencies, ensuring positive credit ratings, lower borrowing costs and private sector buy-in.

In a number of countries, the PPP framework allows for the creation of a dedicated PPP unit. Such units help to increase project quality by ensuring that only feasible agreements are pursued and by providing technical support to the procuring institutions. These units may sit within the ministry of finance, as in Uganda, South Africa, Botswana and Kenya, or under a separate body, such as the Zambia Development Agency. Kenya's PPP unit, which was established through an act of Parliament, generates pipeline projects that must be approved before negotiations begin. The unit is legally permitted to hire technical advisors to help in negotiating PPP contracts, and financial and legal advisors are required to understand the financial instruments and risks involved in PPPs. The newly established PPP unit within the Ugandan Ministry of Finance, Planning and Economic Development has processed only one project, which has yet to be finalised. As the unit is still building capacity, the International Finance Corporation of the World Bank acted as the transaction advisor, while the recipient sector, the Uganda National Roads Authority, provided the technical requirements.

A strong regulatory framework, limits political influence. This requires a political commitment to its implementation and recourse to punitive measures. It also reduces conflict between technocrats and politicians in reaching decisions about the issuance of guarantees, and fosters consistency in policy-making, thereby reducing the cost of guaranteed debt. The framework ensures that guarantees are issued cautiously and that the best possible terms are negotiated with beneficiaries to mitigate the risk of default. In Kenya, for example, guarantees may be issued only for capital projects, thereby limiting borrowing for operational expenses.

There is often a disconnect between the legal framework and what occurs in practice. South Africa's public finance management act is regarded as comprehensive and robust; however, if an SOE does not meet the conditions of the guarantee granted to it, there is no provision to enact sanctions. Furthermore, the act encourages moral hazard by allowing the guarantor to act as a primary obligor, implying that the government is able and willing to service the SOE's outstanding debt to ensure it is not viewed as defaulting.

Contingent liability management is strengthened by the involvement of the debt office

In addition to the legal framework, of equal importance are the institutional arrangements, which indicate the actors responsible for managing contingent liabilities. Many African countries have inadequate institutional frameworks, resulting in weak management of contingent liabilities, including those associated with credit guarantees. Appropriateness of the institutional design and the delegation of responsibilities for the management of contingent liabilities are dependent on the development and degree of centralisation of public financial management systems. Irrespective of the context or chosen arrangements, it is critical that the institutional framework facilitates communication and co-ordination between stakeholders (see Box 2). This allows for timely and accurate information sharing, ensuring that proactive steps can be taken to limit guarantees being called upon.

Box 2: Communication and co-ordination with SOEs

Communication and co-ordination between the ministry of finance, particularly the debt management office, and SOEs ensures that policy makers are cognisant of SOEs' needs and are less likely to implement policies that will negatively impact SOEs' commercial viability. Adding conditions to credit guarantees is one tool with which the central government can improve oversight and co-ordination and foster increased risk awareness among SOEs.

The importance of oversight and communication is evident in South Africa, where policy-makers failed to apprehend widespread public resistance to its implementation of open road tolling. This decision by the central government has reduced the profitability of the well-managed national roads agency and increased its need for guarantee-backed loans. Increased oversight also allows the central government to ensure that the loans they guarantee are utilised primarily for infrastructure or development, rather than for operational activities.

Research by the Organisation for Economic Co-operation and Development (OECD 2005)[2] and Ülgentürk (2017),[3] presented at CABRI's contingent liabilities policy dialogue, acknowledges that institutional setup is dependent on context, but recommends centralising contingent liability management through the involvement of a debt management office (DMO).

A DMO typically has oversight of the government's financial position and is consequently well placed to assess the costs and risks of projects and guarantees. In many African and OECD countries, DMOs are involved in contingent liabilities arising from guarantees to SOEs, but not those arising from guarantees to local government, banks and PPPs.

There are DMOs (in South Africa, for example) where there is oversight over both the financial assets and the liabilities of the government. In Kenya, the Fiscal Commitment and Contingent Liabilities unit has been set up within the DMO. The Kenyan National Treasury is currently working to ensure that this unit is well equipped to manage contingent risk. In Uganda, measures are being taken to involve the DMO in the analysis of contingent liabilities arising out of PPPs and SOEs. In many other African countries, establishing the overall financial position is still problematic, as different functions related to government assets and liabilities are not yet centralised or the information is not easily accessible.

Where the risk management or middle office of the DMO is functional, managing risk from contingent liabilities in parallel with direct liabilities is a natural extension of the DMO's responsibilities. DMOs, through either the cash management or back office units, are also well placed to manage revenue for, and applications from, contingent reserve funds (see Box 3). Collection and dissemination of quantitative information on contingent debt, which many of the delegates identified as problematic in their countries, may also be improved if the mandate for this resides with the DMO.

Box 3: Contingency reserve funds

The pervasiveness of badly managed SOEs in Africa and the unpredictability of guarantee payouts by the government, reiterates the importance of establishing contingency reserve funds. These funds act as fiscal buffers and limit pressure on the fiscus. They may also make the cost of contingent liabilities more transparent, thereby establishing links between contingent liabilities and the budget. Although reserve funds are never enough to cover all costs, they do act as a buffer. Political support for reserve funds has been limited, as seen in Zambia, where fiscal deficits and budgetary pressures are used by senior bureaucrats to explain the unfeasibility of funding contingent reserves.

There is concern that reserve funds increase the likelihood of moral hazard (i.e. the possibility that SOEs' knowledge of these reserves may increase their default proneness). Charging beneficiaries a risk-related fee, which helps to fund these accounts, may motivate SOEs to issue debt on the strength of their own balance sheet, by increasing the cost of applying for a guarantee. This will also encourage SOEs to find innovative ways to generate independent revenue streams.

Proactive management of contingent liabilities begins with a credit risk assessment

Analysis of credit risk deriving from explicit contingent liabilities is a critical stage of contingent liability management. However, most countries at the dialogue were of the view that their credit risk assessment was inadequate. If conducted appropriately, such analysis ensures that the government's risk exposure is manageable and sustainable. Credit risk

2 OECD (2005) *Advances in risk management of government debt*. Paris: OECD Publishing.

3 Ülgentürk L (2017) *The role of public debt managers in contingent liability management*. OECD Working Papers on Sovereign Borrowing and Public Debt Management, No. 8. Paris: OECD Publishing.

analysis allows debt managers to establish quantitative measures, which together form the basis for risk mitigation strategy design, reporting and disclosure. It provides the relevant authorities with an understanding of the risk exposure from guarantees, and guides them as to whether this form of support is preferable to others. Common approaches to credit risk analysis include: (i) industry-specific credit scoring; (ii) statistical models, which measure the probability of default using historical data; (iii) scenario analysis using deterministic or random simulations; and (iv) structural models, whereby option pricing is used to calculate default.

Creation of a credit risk framework ensures that the chosen risk assessment methodology is context appropriate. The framework simultaneously extends beyond risk assessment tools and recognises that credit risk analysis cannot be guided solely by technical tools.

It is important that this framework accounts for the nature of the contingent debt portfolio, availability of data, total government risk exposure and financial, technical and human resource constraints. The risk framework supports the risk assessment tools best when it is flexible enough to allow the methodology used to change according to market developments, facilitates collaboration between the debt office, other relevant technocrats and bureaucrats, and permits leveraging other entities, such as credit ratings agencies, when information is scarce. Finally, a well-developed credit risk framework is fundamental to limiting the government's risk exposure, as it ensures that procedures are in place that allow for approval of contingent risks only if sufficient justification is provided.

Measurement is key for timeous identification and mitigation of fiscal risks arising from contingent liabilities

For risk to be adequately considered by decision-makers during the guarantee approval process, it is necessary that the credit risk assessment results in clear quantitative measurements. Measurement allows for: (i) informed decision-making based on cost and risk; (ii) quantitative limits for contingent liabilities; (iii) disclosure of relevant statistics; (iv) calculation of the government's fiscal risk exposure; (v) pricing of instruments, which informs the fee or premium charged to the beneficiary; (vi) recording of guarantees in the public financial accounts; (vii) assessment of the impact of the contingent liability on risk-sharing with private partners in PPP agreements; and, (viii) perhaps most importantly, authorities to include guarantees in conventional budget processes.

Measurement, while essential to all aspects of contingent liability management, is a complex and technically demanding task. There are several different measures (outlined in the Table 1), which, although necessary for various uses, create additional challenges. These challenges were reiterated by the policy dialogue's participants, who indicated that measurement of contingent liabilities in their countries is weak. Kenya noted that although they report on guarantees, these are not quantified. There was seen to be a skills constraint, compounded by inadequate access to and consistency of data.

Establishing country-specific measurement standards is a way to improve accuracy and consistency in measuring guarantees. Moving away from cash-based budgets, which obscure contingent risk exposure, would allow quantitative measures to assume greater importance and efficacy. This would, in turn, increase transparency and accountability by limiting politicians' extension of guarantees and resources for personal agendas.

Adequate disclosure and auditing of guarantees to SOEs increases fiscal credibility

Once guarantees have been analysed and quantified, it is necessary to disclose, in financial statements and budget documents, these measures of volume, likelihood of materialisation and impact on the fiscus. It is also valuable to publish information on the beneficiaries of the guarantees, and the government's justification for providing this form of support (see Box 4). Improved disclosure of guarantees

Table 1: Measures of contingent liabilities

Face value (maximum possible loss)	Maximum probable loss (cash flow at risk)	Expected loss	Unexpected loss	Market value
Full nominal value of the contingent liability corresponding to the maximum possible loss	Maximum loss that may occur at a given confidence level, when the exposure is measured through probability distribution of losses	Present value of the expected future payments times their respective probabilities, the mean of the distribution of losses	Difference between the maximum probable loss and the expected loss, indicating the risk of the contingent liability	Expected cost and the risk premium, corresponding to the price that the market would charge for the contingent liability

facilitates informed policy-making and may limit growth in contingent debt. As noted at the policy dialogue, consistent and comprehensive dissemination of information to parliament also increases accountability, predictability and fiscal credibility, allowing for reduced borrowing costs.

Box 4: Disclosure of organisations under review

The dialogue's participants expressed concern that publishing information on organisations in distress or under review may further impede their SOEs' ability to raise capital. The expected losses are, however, reported as part of the total contingent liability portfolio. The benefits of reporting are enhanced if the data on expected losses from a guarantee portfolio are disclosed; however, very few among the dialogue's participants disclose these.

The country representatives at the policy dialogue were unanimous that disclosure of contingent liabilities is inadequate and that information included in budgets lacks transparency or is overly complex. A primary reason for this is that the responsibility for disclosure lies with a number of parties. It also became apparent at the dialogue that the onus for providing information is often placed on SOEs that may have inadequate incentives to provide the ministry of finance with comprehensive and consistent information on their guaranteed loans.

Many African countries, including those with relatively strong regulatory frameworks, have no legal obligation to disclose guarantees in budget documents. Kenya, on the other hand, began disclosing guarantees in the budget in financial year 2016/17. Uganda's Public Finance Management Act of 2013 also requires that existing guarantees, and analysis of the risk associated with those guarantees, is reported to Parliament with the annual budget.

Varied definitions of contingent liabilities, and divergence between accounting and statistical standards, further impede disclosure efforts. Accounting standards require guarantees to be reported as liabilities on the balance sheet only if there is greater potential of materialisation than not, and if the debt owed is measurable. Statistical standards acknowledge contingent liabilities only if they materialise and when payment is due.

Auditors play an important role in reviewing the quality of information disclosed according to these two standards. Effective auditing processes improve both disclosure and management of contingent liabilities by ensuring that the responsible authorities within the ministry of finance are aware of procedural challenges. The disparity in accounting and statistical standards and definitions of contingent liabilities also hinders auditors, as their clients often have a contrary understanding of what is required. Consequently, disputes ensue about whether they are over-auditing, and wasting resources, or under-auditing, and missing crucial information. In Egypt, auditing is seen to be inadequate and unhelpful, partly because of time lags between financial statements and audit reports. Timeous audits are required so that proactive measures can be taken to limit distress. This requires strong relationships between stakeholders and clear and open communication. This has been observed in Mauritius, where auditors approach actuarial experts within the ministry of finance for guidance, improving identification of both direct and indirect contingent liabilities.

Conclusion

Increased awareness of the potential fiscal risk associated with guarantees to SOEs has led to governments playing a more active role in mitigating such risk. This was evident among the countries attending the policy dialogue, which have made progress in their strategic management of contingent liabilities in recent years. The more effective of these management strategies have taken a holistic and centralised approach, which includes efficient institutional arrangements, regulatory robustness, risk analyses, measurement, and appropriate disclosure and reporting practices.

Despite this progress, politicians continue to issue guarantees to fast track infrastructure development and solicit political favour, while avoiding budget constraints and limiting accountability. The dialogue revealed that while in most countries there are legal frameworks for contingent liabilities, institutional arrangements for their management remain inadequate. These countries also face difficulties in data collection, recording and analysis, implying that decision-makers do not receive a holistic assessment of fiscal risks.

CABRI recognises that addressing these challenges is critical to improving risk management. We will continue, therefore, to work with selected African countries on these focus areas to ensure that fiscal risk from contingent liabilities remains sustainable.

Acknowledgments

The policy dialogue was made possible through the kind assistance of the Deutsche *Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH* on behalf of the German Federal Ministry for Economic Cooperation and Development (BMZ) and the European Union (EU).

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Implemented by:

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CABRI would also like to thank the Swiss State Secretariat for Economic Affairs for supporting the Secretariat's work.

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