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CONCEPT NOTE

POLICY DIALOGUE ON MANAGING CONTINGENT LIABILITIES POST COVID-19

Virtual Meeting – 26 March 2024

Focus: *''Increasing use and/or mismanagement of Contingent Liabilities in Africa exacerbated by the effects of COVID-19 – are some of the main contributing factors to unsustainable debt levels, which compromises debt transparency and accountability and threatens sustainability of public finances".*

1. Background

Managing government cash (explicit financial asset) and government debt (explicit financial liability) either in their integrated or separated form may be considered long standing tasks of public financial management in their main domain of public debt management with the cross-cutting risk management, which gradually emerged since the past few financial crises as an important tool to quantify debt and cash management objectives.

However, managing (or mismanaging) contingent liabilities (explicit or implicit) arising beyond the central and/or general government with or without the underlying risk management has seen many countries come under close scrutiny and receive negative publicity as a consequence of that.

The challenges posed by COVID-19 in managing public finances globally in the last two to three years warrant going back briefly to the description of government's liabilities of which contingent liabilities are a part and how these differ across categories.

Further, the operational aspects of contingent liability management need to be strongly anchored in clear legal and/or institutional framework. Both government's direct and contingent liabilities whether explicit or implicit constitute government's fiscal risks.

Table 1: Fiscal Risk Matrix

Explicit Liabilities	**Direct Liabilities**	**Contingent Liabilities**
Government liability as recognized by law or contract (Legal Obligation, No Choice)	Foreign and domestic sovereign debt Budget expenditures – both in the current fiscal year and those legally binding over the long-term (civil servant salaries and pensions)	**G**uarantees for borrowing and obligations of sub-national governments and SOCs **G**uarantees for trade and exchange rate risks **G**uarantees for private investments (PPPs) **S**tate Insurance Schemes (Deposit Insurance, Private

		Pension Fund, Crop **I**nsurance, Food Insurance, War-risk Insurance) **U**nexpected compensation in legal cases related to disparate claims
Implicit Liabilities	**Direct Liabilities**	**Contingent Liabilities**
Moral obligation of government that reflect public and interest group pressures (Expectations, Political Decision)	Future public pensions if not required by law Social security schemes if not required by law Future health care financing if not required by law Future recurrent cost of public investments	**D**efaults of sub-national governments and SOCs on nonguaranteed debt and other obligations **L**iability clean-up in entities being privatized **B**ank failures (support beyond state insurance) **F**ailures of nonguaranteed pension funds or other social security funds **E**nvironmental recovery, natural disaster relief

Source: Polackova Brixi & Schick, 1999, 2002

Contingent liabilities are financial obligations the government may owe or be obliged to pay to another party, only if specific conditions/events upon which they are contingent, materialize. While government has a legal obligation stated in law and/or regulations to pay financial claims arising from direct liabilities - with regard to contingent liabilities, most of which are off-balance sheet (from a cash accounting perspective), government largely has a moral obligation, except for the explicit ones such as guarantees (refer to table 1).

While government may be considered the risk bearer and by implication the risk manager of last resort (unless government self-insure or pass the risk on to insurers for a nominal premium), the complexities arising from recording, assessing, controlling, reporting and monitoring contingent liabilities may first require checking how various international statistics, accounting and reporting frameworks/standards such as the International Public Sector Accounting Pronouncements and Government Finance Statistics define what government is and how the treatment of contingent liabilities should be.

Even the principle of risk bearer of last resort, the government is presumed to be when it comes to fiscal risk management (of which contingent liabilities forms a part) may require cost and benefit analysis. Intergenerationally and across time, the question may be at whose cost it is for government to be the risk bearer of last resort and equally at whose benefit it is when it comes to contracting and managing long-term fiscal liabilities/obligations?

2. Rationale and Objective(s)

A report[1] by the Department of Finance in Ireland, starts with the following reminder: **"A comprehensive budgetary framework includes a complete evaluation of financial obligations – both contingent and realized. On this basis, the recording and monitoring of both Contingent and Off-balance sheet liabilities is essential for a prudent fiscal sustainability analysis".**

If all plausible scenarios in the management of contingent liabilities over and above the baseline financial and credit risk analysis have been factored in to the best efforts and capabilities of those responsible for the task:

(i) What challenges might the sudden and unexpected occurrence of COVID-19 have caused?;
(ii) Did most implicit liabilities transpired into explicit direct liabilities or added more to the contingent liabilities?;
(iii) Are there prudent measures countries have taken to mitigate risks to fiscal and debt sustainability even as human lives were saved as should be and small-to-medium sized enterprises received some budgetary support in the first two years of COVID-19?;
(iv) Is there a way of assessing how the mitigation of risks owing to rising contingent liabilities been different this time than under any other crisis/challenge in the past and;
(v) What practical and successful lessons are there for other countries to implement going forward?

3. Themes for the policy dialogue on managing contingent liabilities post COVID-19

3.1. Legal and Institutional Framework related to Government Contingent Liabilities

Starting from the hypothesis that there is a legal framework for sovereign debt[2], what about contingent liabilities that are or should be part of borrowing and other related financing?[3]

The legal framework[4] should clarify the authority to borrow and to issue new debt, to hold assets for cash management purposes, and if applicable, to undertake other transactions on government's behalf. Complementing the guidelines, another publication by the IMF[5]

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[1] An Roinn Airgeadais (2021). Contingent Liabilities: an Overview. Economics Division of the Department of Finance, Ireland (finance.gov.ie)

[2] Rault, CJ. (2015). *The Legal Framework of Sovereign Debt Management*, Schriften zur Restrukturierung, Institut fur Interdiszilinare Restrukturierung (iir), Volume 9

[3] World Bank (2021). Debt Management Performance Assessment (DeMPa) Guide

[4] Guidelines for Public Debt Management (2001, 2014). IMF/World Bank

[5] Manual on Fiscal Transparency (2007). IMF

stipulates that in addition to covering taxation and public expenditure, the framework for fiscal management should include the primary legislation, such as budget system law or debt management law that covers all transactions that result in a change in public assets and liabilities. Further to the legal requirement for debt and asset management, there should also be requirements for the transparent management of nondebt liabilities, including monitoring government guarantees, unfunded pensions, arrears and any other contractual obligations of government.

The Guidelines (2014) read in conjunction with the Manual (2007) further indicate that the organizational framework for debt management should be clearly specified and mandates and roles well-articulated. The granting of government guarantees should legally rest with the Minister of Finance or the Head of the Agency responsible for debt management.

With regard to government guarantees – if the (primary) legislation does not set limits on guaranteed debt, it may be critical that the (secondary) regulations provide clear criteria for consideration and approval of guarantees.

3.2. Policy (and Strategic) Framework for the Issuance and Management of Contingent Liabilities

While the design of government programs may be premised on achieving and meeting developmental objectives and societal needs as a matter of first principles, government programs should take into account the volatility of public financing requirements and the impact such programs have on the overall risk exposure of government[6]. Since the main source of government's contingent liabilities at least from the explicit category is government guarantees or extra-budgetary support to State Owned Enterprises and sub-national governments.

3.2.1. How might the issuance and ongoing management of contingent liabilities or the incurrence of government obligations in the most indirect way help achieve government's broader policy objectives?

3.2.2. Are there strong arguments for market failure as a reason for governments to massively issue government guarantees especially after the global financial crisis of 2009?

3.2.3. Are State-Owned Enterprises delivering the results intended for being labelled as the engine(s) of economic growth to warrant receiving the state guarantees to extend they have received?

[6] Polackova, H. (1998). Government Contingent Liabilities: A Hidden risk to Fiscal Stability. Policy Research Working Paper. 1989. World Bank

3.3. Contingent Liability Management Practices Post Covid-19

Through a discussion on contingent liability management practices in two East African countries being Rwanda and Kenya, which will also encompass both the legal, policy and tactical framework approaches employed in the two countries towards mitigating the rise and the realization of contingent liabilities in the post COVID-19 era, several line(s) of enquiry arise as a guideline to frame discussions on the findings:

Examining government's broad policy objectives of issuing loan guarantees in terms of meeting development objectives. Further,examine whether On-Lending where government issue securities and/or obtain a loan at favourable rates and on-lent to government agencies in terms of meeting the same development objective(s) is considered a better option or not.

Determining whether government's pricing of loan guarantees might be a deterrent for entities to rely on the strength of their balance sheet even as government is prepared to offer balance sheet or liquidity support or is the pricing more reflective of the specific sector (differentiated and perhaps more complex) risk that is priced at a significant premium or mark-up.

Seeking to explain how loan guarantees and other contingent liabilities are managed alongside government's more direct liabilities such as loans or bond portfolio. Is there or is government considering a debt ceiling including both loan guarantees/other contingent liabilities and the direct debt obligations (loans and/or bonds)?

What might be the role of a high level advisory committee, if it is there? - for example a Fiscal Liability Committee (in the case of South Africa) or something equivalent that advises and recommend loan guarantee or other borrowing requests brought by other entities of government to the Minister of Finance. How might the committee be structured (is it representative enough?) and how is the approval process being undertaken, e.g. voting on requests, etc.

Have the budgetary process progressed to a stage where contingent liabilities are fully managed as part of government's fiscal risks, if notwhy not? Is government publishing a fiscal risk statement and if so how often? Are contingent liabilities and other forms of fiscal risks reported differently, and if so, what might be the reasons?