DISCUSSION PAPER

CABRI - virtual peer learning and exchange event on the risks to national budgets in Africa, posed by contingent liabilities and PPPs, during the COVID-19 pandemic.

1. INTRODUCTION

The management of contingent liabilities and the enormous risks they pose to the fiscus is a concern across all the regions in Africa. Despite progress made with reform efforts to build capacity in the management and monitoring of contingent liabilities, the risks have increased, and the claims are now threatening the financial stability of Governments.

Further progress towards reforms are hindered by political interference, policy uncertainty and challenges persist such as outdated business models and weak institutional arrangements related to governance and oversight. The peer learning and exchange event applies a holistic and strategic approach to better understand the challenges and mobilize the right capabilities for effective execution in addressing the potential risks that implicit and explicit contingent liabilities pose to Governments and the fiscus.

CABRI's virtual peer learning and exchange event on 22 and 23 September 2020 will convene government officials from 21 African countries working in Public Debt and Budget Offices at the Ministries of Finance as well as representatives from selected State-Owned Entities (SOEs) and other relevant stakeholders, such as the African Development Bank (AfDB), MEFMI, Agence UMOA-Titres (AUT) and AFRITAC – East.

The peer learning and exchange event provides a platform for knowledge sharing on country experiences and the lessons learned while implementing reforms aimed at improving the management of contingent liabilities and oversight over SOEs. This includes the successes, challenges and shortcomings experienced on the continent.

This discussion paper is based on the findings of three case studies covering West Africa, South Africa and Kenya. The paper will be finalised following discussions and inputs provided during the virtual peer learning and exchange event.

This paper provides an overview of (i) the risks posed by contingent liabilities to national budgets, (ii) the challenges/issues countries are facing, (iii) important lessons learned, and (iv) proposed suggestions on where to go from here in terms of policies, frameworks and implementation.

2. OVERVIEW

Contingent liabilities are becoming a significant source of fiscal risk on the African continent

Budgetary risks emanating from Government contingent liabilities and direct fiscal transfers (equity injection) by the state to SOEs are on the rise. While the issuance of state guarantees was initially used to reduce the costs of doing business and to lower borrowing costs, as a result of increasing SOEs borrowing requirements, overtime these fiscal instruments were utilised to prevent guaranteed SOE debt defaulting due to liquidity and solvency challenges.

To avoid SOEs defaulting on guaranteed debt due to their vulnerable financial situation emanating from higher operational costs and revenue constraints, governments instead opt to make direct capital injections and provide budget support to SOEs. In this way, the affected SOE's balance sheets are strengthened to enable them to meet maturing guaranteed debt repayment commitments.

Contingent liabilities, therefore, have impacted debt levels as capital injections, or budget support to SOEs were funded primarily through government debt. Total debt has therefore increased sharply and is approaching unsustainable levels. This can mainly be attributed to the impact of repeating bailouts, capital injections to struggling State Owned Corporations (SOCs), claims by Public Private Partnerships (PPPs) as well as the impact of COVID-19.

<u>A number of State-Owned Entities are in financial distress and are making a loss</u>

Beneficiaries of HIPC and MDRI in Africa saw the opportunity to embark on significant public sector infrastructure investment programmes (Africa needs $100 billion of capital investments per annum), mainly through their respective country SOE sectors. Certain sectors were identified as the major "drivers" for the delivery of economic infrastructure, in particular the transport and energy sectors. Under normal circumstances SOEs are encouraged to operate on the strength of their own balance-sheets. However, to support SOEs, government guarantees were utilised to keep the cost of public sector infrastructure financing as low as possible.

Due to various reasons, such as *rising tariffs (i.e. administrative costs) and financial mismanagement,* many SOEs are constantly making losses, which have in some way contributed to government being required to provide fiscal support, either in the form of guarantees or direct budgetary transfers, to support SOEs in financial difficulties.

SOEs in the energy sector are financially the poorest performers, mainly as a result of low electricity tariffs (West and East Africa). Tariffs set by the regulator do not reflect depreciation charges and the cost of electricity bought from independent power producers.

The question remains, how much are Governments (through the budget) prepared to support these financially unsustainable entities and what is the ultimate cost to the fiscus? The future and continued existence of some of these entities in distress, remains a political decision and may therefore not be informed by any financial sustainability analyses.

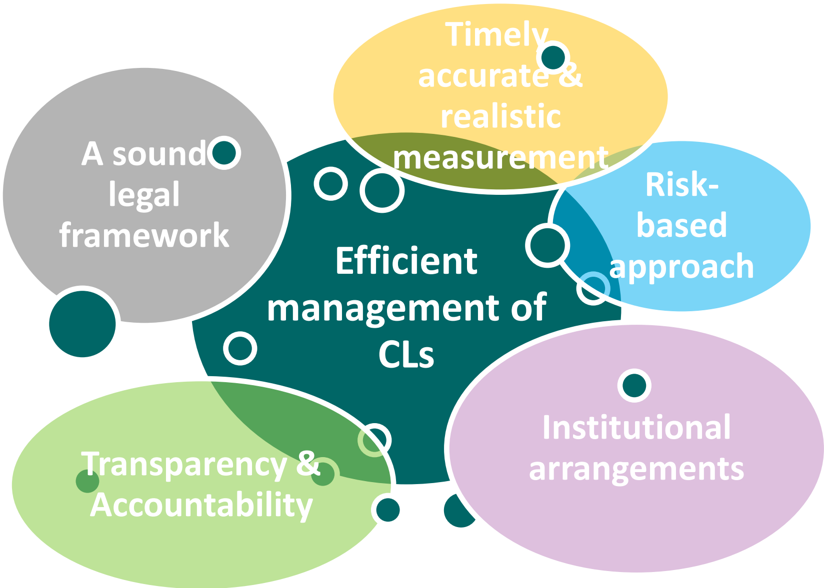
3. THE CHALLENGES COUNTRIES ARE FACING

Countries in East, West and Southern Africa have identified that the most significant barriers or challenges in managing contingent liabilities are:

- Bureaucracy (e.g. irrelevant or cumbersome rules, lengthy approval cycles, etc.).
- Lack of resources/capacity (e.g. insufficient budgets, people, tools, support).
- **Poor information systems (e.g. inaccurate, outdated, missing, or confusing data). This is considered as the most important barrier.**
- Authority issues (e.g. lack of decisions making responsibilities).
- Moral hazard as SOEs believe that whatever happens, the government will provide support due given their strategic position.
- SOE mismanagements
- Poor monitoring of public corporations

- Unclear regulatory framework concerning contingent liabilities and fiscal risks

At the regulatory and institutional level



The regulatory framework in West African countries are considered as limited and do not cover the management of contingent liabilities adequately. Only a few countries have developed legal frameworks, however in many instances these are not fully adhered to or implemented.

Legal frameworks for the management of public debt need to make specific provision for contingent liabilities, particularly guarantees provided to and the debt of public and private entities. This ensures macro-fiscal sustainability through promotion of fiscal transparency, accountability and discipline in the management of contingent liabilities and public debt. From a micro perspective - clear and flexible interactions between different stakeholders, strengthens their commitment to and execution of various guaranteed programs and projects. This is further supported by adopting a risk-based approach to ensure better assessment of the various initiatives undertaken.

In most West African countries, the institutional framework has not established a liability management and coordination unit or committee, where contingent liabilities could be monitored or where recommendations could be made to inform decision-making authorities on various findings and matters affecting budget risks.

Existing institutions, such as the debt and budget offices, offices of the accountants general, and even parliaments do not fully perform their oversight role in managing contingent liabilities. These shortcomings persist despite clearly defined regulatory frameworks which outline the responsibility of the respective Ministers of Finance. This has led to poor coordination between the mentioned (relevant) divisions, weakening the monitoring of public enterprises and PPPs contributing to the risks that contingent liabilities and PPPs pose to governments and the fiscus. In addition, essential technical capabilities and skills to measure and analyse risks are limited.

This has impacted the ability of countries in West Africa to comply with standards (accounting and IMF requirements) when reporting on contingent liabilities. Unreliable data and the availability of information are the main contributory factors.

Only two countries in the region produce adequate reports on contingent liabilities and fiscal risks. The remaining countries address them partially in debt reports or other types of reports. The sharing and disclosure of information is not seen as a widespread or common practise in most West African countries.

In South Africa - where State-Owned Corporations (SOCs) experienced liquidity challenges, the onus rests on government to step in and provide the necessary support. This weakens public finances further especially when the SOCs are unable to utilise government guarantees and other support to turn their financial situation around.

Rating actions on SOCs are *either entity-specific or the result of sovereign credit rating concerns*. *Public sector finances are viewed holistically* by the credit rating agencies. The sovereign rating serves as a "country credit rating "ceiling" that places a "lid" on all corporate ratings in the country.

Administrative prices -High and increasing tariffs may assist the SOC's financial position, *but it also raises the cost of doing business in the country*. While this may be advantageous to the SOC's creditors, it is an undesirable situation for the private sector generally. For this reason, collaboration between the SOCs and the private sector must be enhanced.

***SOC Boards and management must have the requisite skills* to deliver on their respective mandates** - S*hareholder departments should* provide the necessary strategic guidance and shareholder monitoring over SOCs, including financial performance monitoring. To perform these functions effectively, officials within government departments need specialised technical knowledge and experience to appreciate the strategic interplay of the respective stakeholders' mandates and functions. *Risk mitigation strategies and initiatives* and other shareholder support measures must be identified where required and the necessary action must be taken speedily.

***The more transparent and clear the fiscal* and SOC finances are** the easier investors will find it to take critical, swift, and informed decisions. When all stakeholders have access to similar relevant data, *inappropriate SOC business models and SOC capital structures* are easier to detect as well as operational inefficiencies that introduce unnecessary costs to their operations.

4. IMPORTANT LESSONS LEARNED

a. Conditions attached to government (Budget) decisions regarding the issuance of guarantees are *unrelated* to the reasons (causes) why guarantees are applied for

In South Africa, the rapid increase in guarantees over the period 2008/09 to 2018/19 is mainly attributed to *poor governance; inappropriate business models; policy uncertainty; costly policy decisions (e.g. earlier rounds of IPP contracts); solvency and liquidity concerns, which have required government (Ministry of Finance)* to provide fiscal support, either in the form of guarantees or direct budgetary transfers.

Failure to address the source of the problem, in a targeted manner, at the time that financing decisions are made, results in "mis-guided" government financing or guarantee support. As a result, Government faces successive guarantee applications and financing requests with limited benefits.

Government guarantees then continue to rise and the SOC's financial performance continue to deteriorate further increasing fiscal risks leading to potentially worse future sovereign and SOC credit rating outcomes.

b. Effective execution of "shareholder" responsibilities over SOCs is critical

Officials within the entities (SOCs) as well as in the **Shareholder Departments** and the Ministries of Finance must take cognisance of possible unfunded developmental mandates that will place a strain on SOC balance sheets, if left unattended. Proper corporate governance principles must be complied with to avoid unwarranted political interference in the day-to day running of the business.

c. When entities are "too large to fail", an immediate "red flag" must be raised

In the case of Eskom (see the South Africa case study), **as the quality of government's exposure deteriorated**, the level of exposure should also have been reduced. To effectively implement such prudent risk management practices, professional "healthy" relationships must exist between government and the SOC management as well as between the SOC management and their respective boards.

A further important **relationship is that between government and the private sector**. The involvement of the private sector introduces an added level of oversight in technically complex operations.

Credit rating agencies also play an important role. Excessive exposure to contingent liabilities can result in multiple adverse credit rating action making countries less attractive as an investment destination.

d. Guarantee conditions must be well-researched, measurable and time bound

The financial analysis undertaken must demonstrate how **post-approval project implementation** will lead to the improved future health of the SOC, prior to guarantees being granted.

e. Clear regulatory and institutional framework matters

Research in West Africa show a country that have a clear regulatory and institutional framework have better practice in contingent liabilities management.

5. WHERE TO FROM HERE

This section provides recommendations for policies, practises and implementation.

Strengthening and building internal capacity to manage contingent liabilities.

- **Concerning the legal and institutional arrangements:**

- ✓ Develop a legal framework to make provision for contingent liabilities, particularly guarantees provided to public and private entities and public entities direct debt. The regulatory framework should clearly stipulate assigned responsibilities, accountability, institutional arrangements and how the interaction between relevant stakeholders (debt office, accountant general office, budget office, shareholder department and SOEs) should be structured in terms of oversight, governance, reporting and sharing of information.
- ✓ Establish an entity/unit to manage contingent liabilities – this entity is normally part of the Public Debt Office (middle office) and its responsibilities are to keep a register of all guarantees issued, make recommendation of new applications to Fiscal Risks Committees (FRC), monitoring of fiscal risks, develop analytic tools and risks mitigating strategies in the management and reporting of contingent liabilities.
- ✓ Implement a Fiscal Risk Committee (FRC), which is an internal committee, with the responsibility to develop practices on government guarantee application processes, and the conditions under which new guarantee applications will be approved. The terms of references of the committee should therefore be clear. Such committees will review any new applications and make recommendations for approval to the Ministers of Finance (or whichever appropriate Minister). The committee will also monitor any risks to the fiscus and financial soundness of SOEs in terms of the conditions under which guarantees were issued.

- **With respect to process, procedures and practices:**

- ✓ Create a central database/register to capture data and keep record of any government guarantee being issued and approved. These records of governments guarantees should be accounted for in the annual Financial Statements of government by the Accountant General's Office for auditing and reporting purposes to parliament
- ✓ To strengthen accountability - SOEs to report on a quarterly basis their financial performances and soundness of operations
- ✓ PPPs are normally managed through a separate entity within the Ministry of Finance. The entity responsibilities are to identify future projects, negotiate contracts, arrangements and agreements with private sector, monitor agreements and claims that may arise from such arrangements between government and the private sector
- ✓ Develop criteria to account and monitor public and publicly guaranteed debt and explicit contingent liabilities
- ✓ Do regular stress testing on the possibility of any materialization of contingent liabilities. This will ensure the government (Ministry of Finance), is prepared and account timely for such risks
- ✓ It is Important to strengthen internal controls of contingent liabilities between various role players. Information should be shared regularly. Debt Offices, Accountant generals and Budget Offices should not work in silos and there should be clear separation of duties. Duplication of responsibilities and reporting structures should be avoided
- ✓ Compliance to conditions under which guarantees were issued should be closely monitored
- ✓ Regular audits in terms of internal and external audits should be conducted annually
- ✓ On budget and off-budget liabilities (debt and contingent liabilities) should be incorporated as part of the total debt of government and published as a consolidated report on government's total exposure. This then forms part of the budget documents prepared, when the Minister delivers the budget speech to parliament

.

- **Transparency and accountability:**

- ✓ Establish a reporting framework for monthly or quarterly publications of contingent liabilities together with public debt reporting practices

- **Building capacity in monitoring contingent liabilities:**

- ✓ Strengthen capacities through training, peer learning and experience,
- ✓ Create and raise awareness of the importance to monitor and manage contingent liabilities in a coordinated manner, involve civil society and create citizen awareness, and, if possible, have regular interaction with shareholder departments and SOEs in terms of matters of mutual concern
- ✓ Ensure oversight entities are fulfilling their roles and responsibilities

Despite the strengthening of institutional arrangement and legal frameworks to manage contingent liabilities, SOEs are still posing risks to the fiscus. This can mainly be attributed to the conditions attached to the issuance of guarantees that are unfortunately *unrelated* to the reasons (causes) why guarantees are applied for in the first instance.

The rapid increase in guarantees, are mainly due to financial position SOEs find themselves, which require government to provide fiscal support, either in the form of guarantees or direct budgetary transfers.

This unhealthy virtuous cycle repeats itself as weak SOC financial performance leads to *more* guarantees being issued to support SOC liquidity and working capital requirement challenges, resulting in higher fiscal vulnerability, higher financing costs and further worsening credit rating outcomes.

What could be the way forward

- **Linking the approval of guarantees to specific conditions**

It is important that the conditions identified are *well-researched, measurable and time-bound (SMART*) and that *the financial analysis undertaken illustrate how post-approval project implementation and execution impacts the future health of the SOC.* For this to occur, a symmetry (full transparency) of financial and "other" technical data, at the project level (and sectoral level, where relevant), is required, between those key stakeholders responsible for generating the data and those responsible for making key decisions regarding the issuance of guarantees or "fiscal bail-outs" (Ministry of Finance).

- **Reliable information available**

Annual Reports (including audited financial statements), Corporate (and Borrowing) Plans and Annual Office of the Auditor-General (OAG) reports on SOCs must be accessible. However, the requirements are *generally broad* and at an *entity level when SOEs apply for guarantees*. The conditions are *unlikely to remedy underlying challenges at the entity (high/macro-level intervention). This then compromises the sustainability and viability of the critical infrastructure project (micro-level execution) under consideration*. Normally, no continuous assessment of post-guarantee approvals is done specifically focusing on how government-guaranteed project financing "feeds through" into an improved SOC financial performance in future.

- **Guarantee approval process**

The process as currently pursued leaves the “door wide open” for SOCs and their Executive Authorities to “generously” apply for government guarantees to be issued. Simultaneously, the Ministry of Finance is poorly placed and capacitated to effectively assess and analyse project-specific guarantee applications. Besides incorrectly scoping the exact data required to assess guarantee applications, the quality of advice is also affected by the lack of credible and timeous project-specific data, resulting invariably in guarantee approvals (or non-approvals) being delayed until such time that the required data is eventually obtained. This delay may result in the entire financing landscape and economic factors on which the financing decisions were initially made, to drastically change (in either direction), rendering the effectiveness of government’s guarantee decisions and approvals to ultimately be extremely poor.

- Strengthening States Owned Entreprises governance and performance monitoring

Without a sound management of public corporations, all efforts will be vain. It required to promote performance-based management within the SOE’s and contract with specific results targets concerning all the guaranties and subsidies that the government will provide. In this instance, Countries should create an effective office of SOE’s, signed a performance contract with SOE and strengthen, innovate the monitoring system to better manage the risk after issuing the guarantee. There is need for better coordination between financial tutor and technical tutor of SOC’s.

6. CONCLUSION

As indicated, most countries in Africa are finding it extremely difficult and challenging to manage contingent liabilities and the adverse risks it poses to the national fiscus. The poor management of contingent liabilities in Africa is one of the main contributing factors to higher debt levels. COVID-19 has made it more challenging as governments have the added demands of supporting entities in distress with having limited resources to do so effectively.

The aim is to provide African countries with a guide and possible direction in strengthening their oversight and governance function regarding the management of SOCs and in developing a holistic and strategic approach to the financing of public sector infrastructure. Through peer learning and exchange as well as targeted in-country engagements, a platform is provided for the development of locally driven innovative solutions with actions plan for sound management of contingent liabilities.