MANAGEMENT OF CONTINGENT FISCAL LIABILITIES EXPOSURES: THE SA EXPERIENCE

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DEFINITION: CONTINGENT LIABILITIES

A Contingent Liability *is a loss which depends on the outcome of the contingency. A contingency is a condition or circumstance, the eventual outcome of which, whether beneficial or adverse, will only be confirmed by the course of uncertain future events.*

Source: National Treasury Annual Financial Statements

Source: National Treasury - ALM

EXPLICIT AND IMPLICIT CONTINGENT LIABILITIES

A contingent credit risk is incurred when a party, in most cases a government-owned entity, is unable to meet its financial obligations to third parties that government has **guaranteed**. **(Explicit)**

It could also arise where there is market or public **expectation** for government to support a failed institution that is deemed to be of national interest. **(Implicit)**

IMPLICIT CONTINGENT LIABILITIES

- Hard to identify and to estimate their size - events triggering these liabilities are uncertain, therefore value at risk is difficult to determine. **They may include:**

  - A default of a sub-sovereign, public or private entity on a non-guaranteed debt and other liabilities;
  - Bank failure;
  - Investment failure of a government related pension fund, employment fund, or social security fund;
  - central bank default on its obligations (foreign exchange contracts, currency defence, balance of payments stability); and
  - Residual environmental damage, disaster relief, military financing, etc

IMPLICIT CONTINGENT LIABILITIES (continues)

- **Undisclosed implicit contingent liabilities:**
  - o Bank failure and
  - o Disaster relief
- **Disclosed implicit contingent liabilities:**
  - o Road Accident Fund (RAF);
  - o South Africa's Special Risk Insurance Association (SASRIA);
  - o Unemployment Insurance Fund (UIF);
  - o Compensation Fund (CF); and
  - o Export Credit Insurance Corporation of South Africa SOC Limited (ECIC).

IMPLICIT CONTINGENT LIABILITIES (continues)

- Contingent liabilities from a banking system failure is managed and mitigated through a robust regulatory framework, which shielded SA banks from the 2008 crisis.
- The national budget includes a contingency reserve, which may be used for natural disasters.
- The Annual Division of Revenue Act (DoRA) specifies unallocated funds to any province or municipality that may be released within 3 days up to 3 months following a disaster.
- In terms of DoRA, unspent allocations related to infrastructure may be reallocated for reconstruction and rehabilitation.
- This presentation will focus on explicit contingent liabilities.

LEGAL FRAMEWORK

PUBLIC FINANCE MANAGEMENT ACT (PFMA)

Section 66 of the PFMA prescribes:

The powers of Government and the Public Entities to borrow money, issue guarantees, indemnities and or securities that may bind the National Revenue Fund.

Restrictions on borrowing, guarantees and other commitments

Section 70 of the PFMA stipulates:

The responsibility of Cabinet members for the issuance of guarantees, indemnities and or securities as well as duties of the responsible Cabinet Member. It also stipulates that the Minister of Finance has to concur with the issuance of such guarantees, indemnities and or securities

CONSTITUTIONAL PROVISIONS

- **The PFMA gives effect to sections of the Constitution of South Africa that deals with Finances of the country and requires national legislation:**

– *To introduce generally recognised accounting practices;*

– *To introduce uniform treasury norms and standards;*

– *To prescribe measures to ensure transparency and expenditure controls in all spheres of government;*

– *To set the operational procedures for borrowing, guarantees, procurement and oversight over the various national and provincial revenue funds.*

POLICY FRAMEWORK

UNDERLYING PRINCIPLES

- NT to operate within an appropriate Credit Risk environment;
- Credit risk inherent in all new activities must be subject to adequate controls (procedures);
- NT must operate under a sound credit granting process;
- An appropriate credit administration, measurement and monitoring process must be maintained;
- NT established independent Fiscal Liabilities Committee (FLC).

POLICY ON GUARANTEES (GOVERNMENT SUPPORT)

- To limit the issuance of guarantees;
- Public entities to borrow on strength of balance sheet;
- Use guarantees to support restructuring objectives and infrastructure development program;
- Meeting international agreement obligations;
- Levying guarantee fees to equalise the benefits on borrowing cost.

POLICY GUIDELINES

- ***Guarantees are only issued where:***
  - Appropriate risk management procedures exist;
  - Legislative requirements have been met;
  - Legal advice has been sought;
  - Time limit to the instrument;
  - Termination clause;
  - Maximum financial limits on claims;
  - There is a demonstrable need for government to accept such risks.

MANDATE OF THE FISCAL LIABILITIES COMMITTEE (FLC)

"Optimum management of CLs through"

- Risk assessment of the counterparties' credit quality and advise Minister accordingly;
- Monitor concentration in portfolio;
- Adopt a limit for total liabilities, set conditions and monitor adherence;
- Monitor performance against benchmark of total net debt, provisions and contingent liabilities as a percentage of GDP;

MANDATE - continued

- Advise Minister on approaches/policies;
- Consider applications and make appropriate recommendations;
- Determine appropriate fees and rules for non-payment;
- Consider legal implications;
- Monitor utilisation of guarantees and adherence to conditions;
- To provide oversight on the implementation of the contingent liability policy of the National Treasury;

MANDATE - continued

- Manage the CLs emanating from PPPs;
- Have a holistic view of all CLs;
- Satisfy itself of adequate systems in place;
- To monitor and report claims against state due to non-payment by counterparties and to adopt rules to deal with non-payment; and
- Consider the introduction of a funded contingency reserve account.

REVIEW AND MONITORING PROCESS FOR THE ISSUANCE OF GUARANTEES

ISSUANCE AND MONITORING PROCESS

- SOC establishes business case for guarantee to executive authorities, who if approves, submits the proposal documents to the FLC for review and recommendation to the Minister;

- FLC meetings are held quarterly with special meetings convened when required.

- FLC makes recommendations to the Minister to approve or to concur with the issuance of a guarantee;

- A memorandum with relevant details including the proposal document and recommendation is forwarded to the Minister;

ISSUANCE AND MONITORING PROCESS

- If Minister approves or concurs, a letter based on the outcome of the meeting, including conditions, is sent to the SOC as well as to the executive authorities;

- All guarantees are captured on a guarantees register kept by ALM;

- The register, which includes conditions to which guarantors must adhere, is subjected to verification and audit process to ensure accuracy;

- SOC's and government departments must submit guarantee information, including utilisation to the ALM division quarterly;

ISSUANCE AND MONITORING PROCESS

For the quarterly FLC meeting, the following reports are prepared…

- Report on monitoring of adherence to conditions;
- Report on the quality and level of government's exposure from the guarantee portfolio;
- Report on impact of individual requests on the total guarantee portfolio; and
- Performance against the target sustainability benchmark.

LEGAL ISSUES

- ***Legal advisors of borrower to provide an opinion setting out at least the following:***
  - Borrower has power and authority to borrow;
  - Borrower ensures that its obligations rank at least *pari passu* to other unsecured obligations;
  - Borrower will execute obligations without contravention of applicable laws;
  - Borrower not involved in any court action that may have materially adverse consequences;
  - Consequent to signature, organisational setup and financial status of borrower will not change.

MANAGEMENT OF CONTINGENT LIABILITIES

RISK ASSESSMENT OF CONTINGENT LIABILITIES

Business Risks	Financial Risks
Industry Prospects - Operating Environment - Regulatory Framework Corporate Governance - Adherence to PFMA - Management Quality Market Position - Diversification - Size	Profitability - Cost to income ratio - Net profit margin - EBITDA margin Capital structure - Debt to assets - Debt to equity Cash flow adequacy - Funds from operations/Debt - Interest cover Liquidity ratios - Cash ratio - Quick ratio - Current ratio

Source: National Treasury

RISK RATING METHODOLOGY

- A risk rating methodology is applied to the different indicators for each SOC
- The ratings of are aggregated to determine a risk rating for each of the SOCs
- The ratings of the different SOCs are consolidated to determine a consolidated rating for the portfolio.

REPORTING OF CONTINGENT LIABILITIES

- Monthly, Quarterly and Annual reports are prepared for:
  - Central Bank (SARB);
  - IMF in terms of of the Special Data Dissemination Standard (SDDS);
  - Office of the Accountant General (OAG);
  - FLC, Head of Department (National Treasury) and Minister of Finance;
  - Cabinet

REPORTING OF CONTINGENT LIABILITIES

- All departments records guarantees in their various Annual Financial Statements
- OAG consolidates guarantee figures in the consolidated Annual Financial Statements of the Government;
- Audited Annual Financial Statements of Departments presented to parliament Annually;
- Audited Consolidated Financial Statements of the National Government is presented to Parliament Annually.

GUARANTEE EXPOSURE FOR 2012/13

- Issued guarantees currently at R471.9 billion
- Exposure, representing utilised guarantees at R179.4 billion
- Net debt, provision plus contingent liabilities, including on balance sheet implicit CL at 51.4 per cent of GDP
- Projected to peak at 53.3 per cent in 2014/15

Source: National Treasury

CONCLUSION

- Government assistance used to support infrastructure development program
- Fiscal Liabilities Committee used for evaluation and monitoring of CLs
- Credit risk policy and methodology for managing CLs
- Analysis on all counterparties to determine value and quality of exposure
- Exposure kept at sustainable levels

THANK YOU