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Mitigating the Risk Associated with Contingent Liabilities

by

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The views expressed are those of the author and do not necessarily reflect the views of UNCTAD

Mitigating the Risk Associated with Contingent Liabilities: The Philippines

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CL | Definition and Risk Management Objective

Contingent Liabilities (CLs)

- Classified as either explicit or implicit
- **Uncertain (occurrence, timing, size) – may or may not lead to an obligation to provide funds or other resources**

However, it is necessary that CLs are:

Measured | **Monitored** | **Managed**

TO AVOID UNNECESSARY FISCAL ADJUSTMENTS BUDGETARY SHOCKS, AND PROTECT THE CREDIBILITY OF THE GOVERNMENT

Contingent Liabilities | Coverage

Debt Guarantees to Government Owned or Controlled Corporations

- Credit enhancements to allow corporations to source funding at lower cost or in some cases, to access the capital market by lowering the credit default risk of a corporation.

Contractual Obligations from Public-Private Partnerships

- Risks allocated to the Government, such as regulatory risks, failure to acquire right-of-way, failure to adjust tariffs.
- Also covers termination events, and force majeure scenarios

Risks arising from Natural Disasters and Calamities

- Costs associated to disaster response, relief, and reconstruction (social obligation)

Outline of the Presentation

1. Recognition of CLs
2. Budgeting for CLs
3. Valuation of CLs
4. Monitoring and risk mitigation of CLs
5. Risk Disclosure
6. Lessons Learned

CLM Framework | Origination and Recognition

Origination and Recognition | Guarantees

Debt Guarantees versus Direct Subsidies versus On-Lending

- **Debt guarantees are extended mostly to financially viable government corporations as a form of credit enhancement as allowed by their respective charters.**

- **Direct subsidies are given to government corporations that are not viable given the social good that they are mandated to deliver.**

- **On-Lending Mechanisms – NG borrows in behalf of the GOCC; NG as creditor**

Issuance of Debt Guarantees

NEDA Approvals

Borrowing Approval from DOF

Monetary Board Approvals

GOCC Cash Flow Analysis

BOP Implications

Guarantee Ceiling Implications

GOCC Borrowing Terms and Conditions

Origination and Recognition | Guarantees

Guarantee Fee | DOF Memorandum Circular 1-91

National Government shall collect a guarantee fee of one percent (1%) per annum based on the outstanding balance of the guaranteed borrowing.

Foreign Exchange Risk Cover | Memorandum of Agreements

In consideration of the assumption of foreign exchange risk, the GOCC/GFI shall pay the National Government a fixed fee of three percent (3%) per annum based on the outstanding principal peso balance and interest falling due on the guarantee borrowing.

Ongoing Initiative | Risk-based Guarantee Fee

- Through the proposed Public Financial Management (PFM) Bill
- Instead of charging a flat one or three percent fee, NG would assess every guarantee proposal individually and charge fees based on its risk assessment
- Risky guarantees would call for higher fees and safer guarantees would merit lower fees

Origination and Recognition | PPPs

Project Structuring Stage

Feasibility Study → ICC Approval → NEDA Board Approval → Bidding → Awarding

Value-for-Money Analysis

Risk Allocation in Contract Design

Project CL Management Plan

Initial CL Estimates – entire project life

CLM Framework | Budgeting and Payment

Budgeting and Payment

✧ **In general, appropriations are disaggregated in different parts of the budget to minimize lump-sum appropriations**

Guarantees

- Provisioned in the programmed budget for the fiscal year
- Advances are made by NG in instances where the GOCC can't repay its obligation to avoid GOCC default.
- Advances are booked as receivables of NG and are expected to be repaid by the GOCC, unless reclassified as a subsidy after a certain period of time.
- In some cases, advances (which are considered as GOCC obligations to NG) are restructured to provide more room to GOCC to pay.

RATIONALE: TO INSTILL <u>FINANCIAL DISCIPLINE</u> TO GOCCs WHILE RECOGNIZING THEIR <u>SOCIAL MANDATE</u>

Budgeting and Payment

PPPs

- Provisioned in the Unprogrammed Fund, that can only be accessed when there is excess revenue
- Payments only cover undisputed amounts of materialized CLs
- **ONGOING INITIATIVE: Creation of a CL Fund for PPPs**
  - Trust Fund maintained in the National Treasury
  - Accumulates over time
  - Contains recourse agreements

RATIONALE: TO <u>INCENTIVIZE PROPER RISK ALLOCATION</u>, AND <u>AVOID MORAL HAZARD BEHAVIOR</u> OF IMPLEMENTING AGENCIES

Budgeting and Payment

Natural Disasters

- National Disaster Risk Reduction and Management Fund
- Quick Response Fund (in various agency budgets)
- The Philippines crafted a Disaster Risk Financing and Insurance (DRFI) Strategy aimed at sustaining economic growth through protecting gains from natural disaster shocks.

CLM Framework | Stock-Flow Valuation

Stock-Flow Valuation | Guarantees

Stock Estimates

- **Guaranteed Debt are valued and reported in outstanding nominal value (consistent with Macroeconomic Statistics Standards)**

Flow Estimates

- **DOF conducts an analysis of future cash flows, taking into consideration solvency and liquidity conditions of GOCCs**

Ongoing Initiatives

- **Risk-based pricing for flows estimation**
- **Use of Contingent Claims Analysis (Merton Model)**
- **Use of Options Pricing Model (Black Scholes Model)**

Stock-Flow Valuation | PPPs

Determination of the Maximum Exposure (Stock Estimates)

- Based on Termination Payment Formulas in Concession Agreements
- Initial values are based on the financial models.

- For projects that are yet to be implemented but are expected to be awarded within a fiscal year, either termination or estimates on liquidated damages are used (case-to-case basis).

- Annual estimates are revised according to the progress of the project.

Probability-adjusted estimates and sensitivity analysis (Flow Estimates)

- Stock estimates are adjusted using probability categories.
- Flow estimates use Expected Values
- Shocks on baseline scenario equivalent to an increase in probability categories

Ongoing Initiatives

- Use of stochastic methods to determined more realistic flow estimates
- Inclusion of CLs in PPPs in the Debt Sustainability Analysis

Stock-Flow Valuation | Natural Disasters

Catastrophe Risk Model

- The Catastrophe Model for the Philippines was completed in May 2014 with the following outputs:
  - Historical database for natural disasters
  - Geo-referenced catalogue of all national government assets
  - Disaster Risk model which will generate economic loss values for potential disaster events
  - Assistance in developing a risk transfer instrument

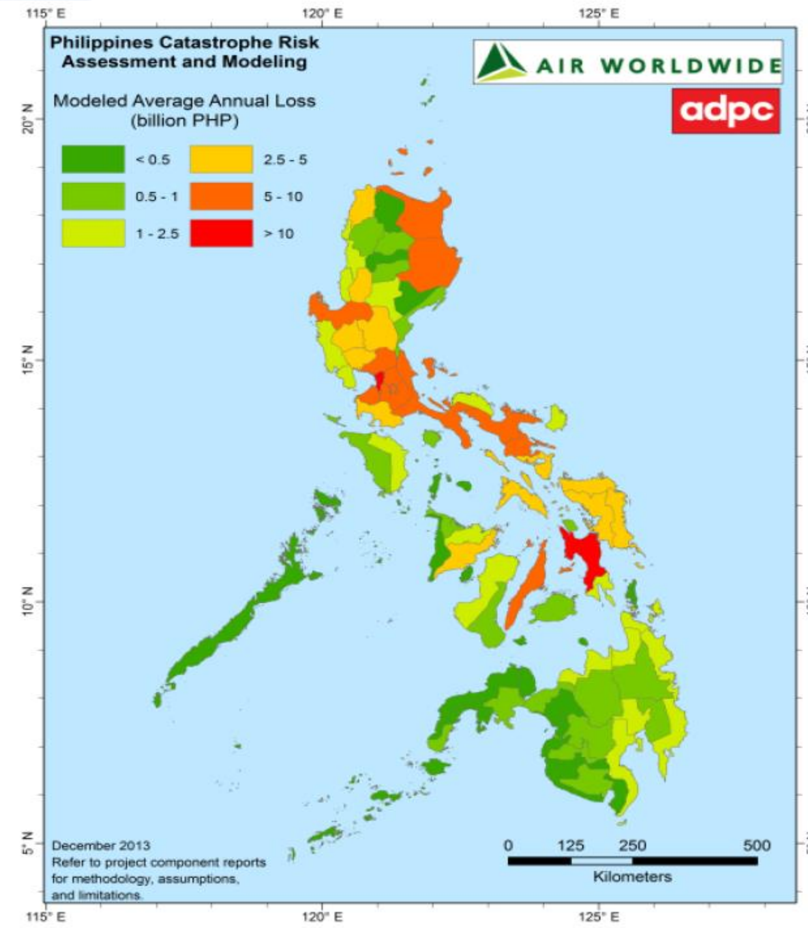
- The model is used in:
  - Determining government's contingent liabilities in the face of disasters
  - Providing foundation in designing risk transfer instruments

Risk Transfer Instruments

- NG is working with the World Bank in structuring a risk transfer product that will leverage the massive financial resources of the international capital markets

Philippine Catastrophe Risk Model (2014)

Notable Results



Source: DOF catastrophe risk profile for the Philippines supported by the World Bank-GFDRR

Future disasters losses could overwhelm Government's ability to finance the cost by itself:

- Long-term Average Annual Loss
  - 206 billion PHP (US$4.6 billion) or 1.8% of GDP in direct losses to public and private assets
  - Additional 42 billion PHP (US$941 million) in emergency response losses (**3.6% of total government expenditure)**
- **Losses equal to those associated with Typhoon Yolanda (Haiyan) are estimated to occur with a 3% annual probability.**
- In the next 25 years:
  - **40% chance of experiencing a loss of more than** PHP840 billion (US$18.8 billion) or equivalent to **7% of GDP**
  - casualties exceeding **70,000 people in one year**

CLM Framework | Monitoring and Risk Mitigation

Monitoring and Risk Mitigation

Guarantees

- DOF conducts periodic financial analyses of GOCCs
- DOF also estimates expected payments as part of the annual budget process

PPPs

- PPP Governing Board
- Development Budget Coordination Committee
- Reporting to Congress

Natural Disasters

- DRFI Strategy
  - Sovereign level – Cat DDO Loan (2011), Philippine Catastrophe Risk Model (completed in 2014), Risk transfer financial instruments
  - Local Government level – initiatives include: LGU Catastrophe pool to provide LGUs with immediate liquidity after extreme disasters, GSIS to increase its capacity to provide parametric insurance policies
  - Household level – Philippine Insurers and Reinsurers Association (PIRA) is conceptualizing a residential insurance pool to provide disaster risk coverage

CLM Framework | Reporting and Disclosure

Reporting and Disclosure

Annual Fiscal Risks Statement

- Contingent Liabilities stock arising from PPPs
- Outstanding Government Guaranteed Debt to GOCCs
- Pending cases that may result to Contingent Liabilities

Bureau of the Treasury Website

- NG Guaranteed Debt Report (Domestic & Foreign)

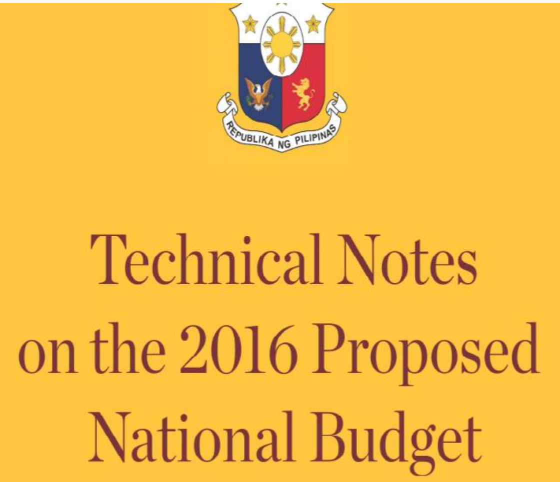
Budget of Expenditures and Sources of Financing

- List of concluded/turned over projects
- Awarded/for construction/under construction projects
- PPP projects in the pipeline

Technical Notes on the Proposed National Budget

- Discussion on NG's Contingent Liabilities
- CLs from PPP projects

Source: DBM Website



Source: DBM Website

Key things to remember

- **Motivation to incur contingent liabilities should not be to "conserve" fiscal space. It must be motivated by policies that aim to incentivize proper risk management and disincentivize moral hazard behavior. (Guarantees vs Subsidies, PPPs vs Traditional Infrastructure, for instance).**

- **Willingness to incur contingent liabilities should be weighed against other potential alternatives (Guarantees versus On-Lending Schemes, for instance).**

- **Upfront recognition of future budgetary outflows caused by explicit contingent liabilities should be done to avoid a dangerous mindset that creating contingent liabilities do not only conserve fiscal space, but also generates revenues.**

Key things to remember

- **Preparedness to settle realized contingent liabilities by budgeting without sacrificing too much fiscal space.**

- **Development of valuation methodologies that are properly nuanced to institutional arrangements and policy priorities.**

- **Continuous monitoring and oversight should be in place to detect possibility of contingent liabilities materializing (SOEs don't go insolvent overnight).**

- **Information linkages are essential and must be embedded in a comprehensive policy framework.**

THANK YOU!