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Mitigating the Risk Associated with Contingent Liabilities

by

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FORESTALLING RISKS FROM CONTINGENT LIABILITIES

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BACKGROUND AND CONTEXT

- Objective of session - reducing risks of contingent liabilities through effective debt management
- Not talking about risks arising from “shocks” – clear case for grants vs commodities/nat disasters
- Lots of measures debt managers can take – happy to debate those
- But much better for us to avoid these risks entirely wherever possible, through:
  - More fundamental policy reconsideration
  - Building risk management into the liabilities
- Presentation – types/scale of contingent liabilities, and potential measures to avoid the risks

A FEW WORDS OF CONTEXT

- 78 countries have debt service to revenue at ≥20%, crowding out major SDG spending
- Rapidly rising – if trends continue, even with high growth, >60% of LICs/80% of LMICs will have service/revenue ratios above 40%
- Major reasons for this are a) access to capital markets; b) hardening of terms (graduation, grants → con → noncon loans); c) domestic debt with much higher costs
- Without 2x financing needs for SDGs and climate change – intending higher loan % -

AND WITHOUT CONTINGENT LIABILITIES !

WHAT ARE “CONTINGENT LIABILITIES ?

- **Supposed to be liabilities which are NOT immediate, are contingent on certain events**
  - **Explicit are those which are guarantees or contracts in which government will assume liabilities**
  - **Implicit are those which are not guarantees but where government would have to assume liabilities**
- **However, increasingly being used to refer to contracts where there are immediate liabilities – for example PPPs – which have an immediate up-front cost in terms of foregone revenue from a project, to pay the cost of the financing**
- **And increasingly paying less attention to the implicit CLs – eg private sector debt….**

KEY TYPES OF CLs, AND THEIR SCALE/SOURCES (1)

1. ***Public-Private Partnerships***

- ***(partly actual liability) -*** most expensive financing. Cost = 3-4 x bonds, equity funders demand 25-30% pa for 10-15 years, lenders to private sector require interest 3-5% > public loans. Often seen as off-budget – but costs divert budget revenue from the project (or even institution eg all airport or port earnings etc) to guarantee profits/repayments
- additional CL if project is unsuccessful – either project managers underestimate costs and gvt has to find additional funds; or extra costs are billed to private sector, private sector goes bankrupt and finance costs fall on gvt, or gvt has to find extra funding when bad projects handed back. In UMICs/OECD, about 25-30% of PPPs go wrong

KEY TYPES OF CLs, AND THEIR SCALE/SOURCES (2)

2. *Financial sector*

- Government having to bail out financial institutions (either public or private)
- Circumstances:
  - Financial sector invests in high risk instruments or mis-forecasts assets/liabilities
  - Public sector financial institutions gradually accumulate deficits which have to be compensated
  - Private or public financial sector invests excessively in government debt, gvt either defaults or pays down/brings interest rates down and fin instits hit by lower returns
- Costs in developing countries have ranged from 20% to 300% of GDP

KEY TYPES OF CLs, AND THEIR SCALE/SOURCES (3)

3. ***Pension and Health Insurance costs*** – funds privatised, cost and income projections inaccurate, massive public funding needed to bail out, often increasing borrowing by government (CEPAL)
4. ***Private sector debt*** – some is explicitly guaranteed, other not but can become government debt if lack FX to externalise
5. ***Parastatal/decentralised debt*** – is of course liability in sense that implicitly guaranteed by central government, and therefore can easily fall back on government if parastatal or decentralised agency cannot pay

WHAT CAN BE DONE ?

- These contingent liabilities generally do ***NOT*** arise from policy recommendations or activities by debt managers – yet they are expected to deal with consequences.
- ***Why ?***
- Measures to deal with them ought to be incorporated in broader policy actions and in the deals themselves so that core public debt portfolio is not subjected to these risks
- What are key measures we should take ?

WHAT CAN BE DONE ?

1. *PPPs*

- preferably use other funds – OECD/IFC/UK Treasury Committee: “not a good funding source”
- build into contracts hierarchy of risk – initially private sector bears cost of underestimating project or finance costs
- many of the projects are guaranteed/cofinanced by official institutions – the guarantee should work both ways – not just to protect private sector against expropriation etc, but also to protect gvts against incompetence/miscalculation by private investors, or even by advisors structuring deals (eg Lesotho hospital project)

WHAT CAN BE DONE ?

2. ***Financial sector***
   - enhance financial regulation and supervision to discourage more risky instruments, including enhancing capital provision
   - provide grants (or concessional loans) to restructure public financial institutions
   - reduce financial institutions' dependence on domestic debt, and analyse clearly risks of changes in policy for financial sector
3. ***Pension and Health Insurance:***
   - do not privatise pension/health insurance, or use guarantees to compensate gvt if problems

WHAT CAN BE DONE ?

4. ***Private sector debt:***
   - do not issue guarantees
   - build economic programmes around higher reserve levels linked to private debt levels
   - ***what for private sector ?***
5. ***Parastatal/decentralised debt***
   - Limit borrowing tightly to least risky instruments and monitor closely in central DMO
   - Build capacity in these agencies to conduct sustainability analysis (CEMLA): until capacity developed and demonstrated, central approval

- **FOR ALL**: include in DSF analysis; make transparent to (+ if appropriate approved by) parliament/citizens

AND THE EVEN BIGGER PICTURE….

- Most of these risks are due to countries being unable to fund their development goals with low/no-risk concessional funds, and forced to turn to more risky and expensive financing instruments
  - The same is true of the one-off payment maturity risks from external bonds, or the high interest costs of domestic debt – countries don't prefer these either
- Also due to erroneous assumption that private sector or decentralisation somehow provide easy solutions to/better management of risk
- In many cases, central debt managers are not even aware of these deals until they go wrong
- If we don't get serious about reconciling SDGs and debt sustainability, by providing concessional finance and taking above measures, the impact of CLs will grow exponentially and undermine SDGs