MEFMI STUDY ON CONTINGENT LIABILITIES

UNCTAD/South Africa Treasury/MEFMI Workshop
on Asset and Liability Management:

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PRESENTATION STRUCTURE

- Objectives
- Definitions and Scope
- Background
- Methodology and Tools
- Expected Outcomes
- Anecdotal Evidence and Emerging Lessons
- Conclusion and Way Forward

Objectives

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Objectives and Scope

Objective of the Study:

- To determine the **stock** of contingent liabilities, assess governments' **approaches** in managing them and come up with a sound **framework for managing** associated risks

- The TORs stipulate:
  - An attempt to **quantify** contingent liabilities
  - Making **recommendations** for better **management** of contingent liabilities, including **limiting** their growth, enhancing **legal frameworks**, suggesting appropriate **institutional arrangements** and **procedures** for pre-approval analysis, down-stream risk monitoring and management in relation to the sovereign balance sheets, adequately **meeting the associated costs,** and ensuring regular **reporting/disclosure**

(Source: Joint Terms of Reference for MEFMI/OECD/RSA Treasury Study on Public Sector Contingent Liabilities in Eastern and Southern Africa)

Definitions and Scope

Definitions and Scope

Contingent liabilities for central government:

- Are those for which a) **payment** including **quantum** and/or **timing** thereof **may be uncertain** (and only estimable probabilistically) and b) would also **depend on future but uncertain event/s**
- Are " **obligations that do not arise unless particular discrete event/s occur/s in future**" (*Public Sector Debt Statistics Guide, 2011).* Guide also acknowledges **uncertainty** of **"when"** or **"how much"** or a **mix thereof**
- Are a) **explicit** if deliberately **contractual** or **legally binding**, or b) **implicit** if **discretionary** and unforeseen but associated with **significant financial, social and/or political cost** if not bailed out, and could further escalate or attract other downstream risks and costs (ultimately for taxpayers/electorate)
- Examples:
  - **Explicit:** guarantees (but not all – others are actual not contingent), public insurance, shareholding/capital provision commitments, indemnities (to cover cost for other parties), some derivatives (e.g. swaps losses), natural/environmental disasters under government
  - **Implicit:** financial bailouts for SOEs' obligations, e.g. their statutory obligations and own guarantees, nationally strategic sectors e.g. banking system, food security, environmental problems not directly under government ownership/control, etc.
- Intervention **helps reduce and make certain the costs or benefits** of what may be **otherwise** perceived as **too risky** a business or lending to undertake

Definitions and Scope

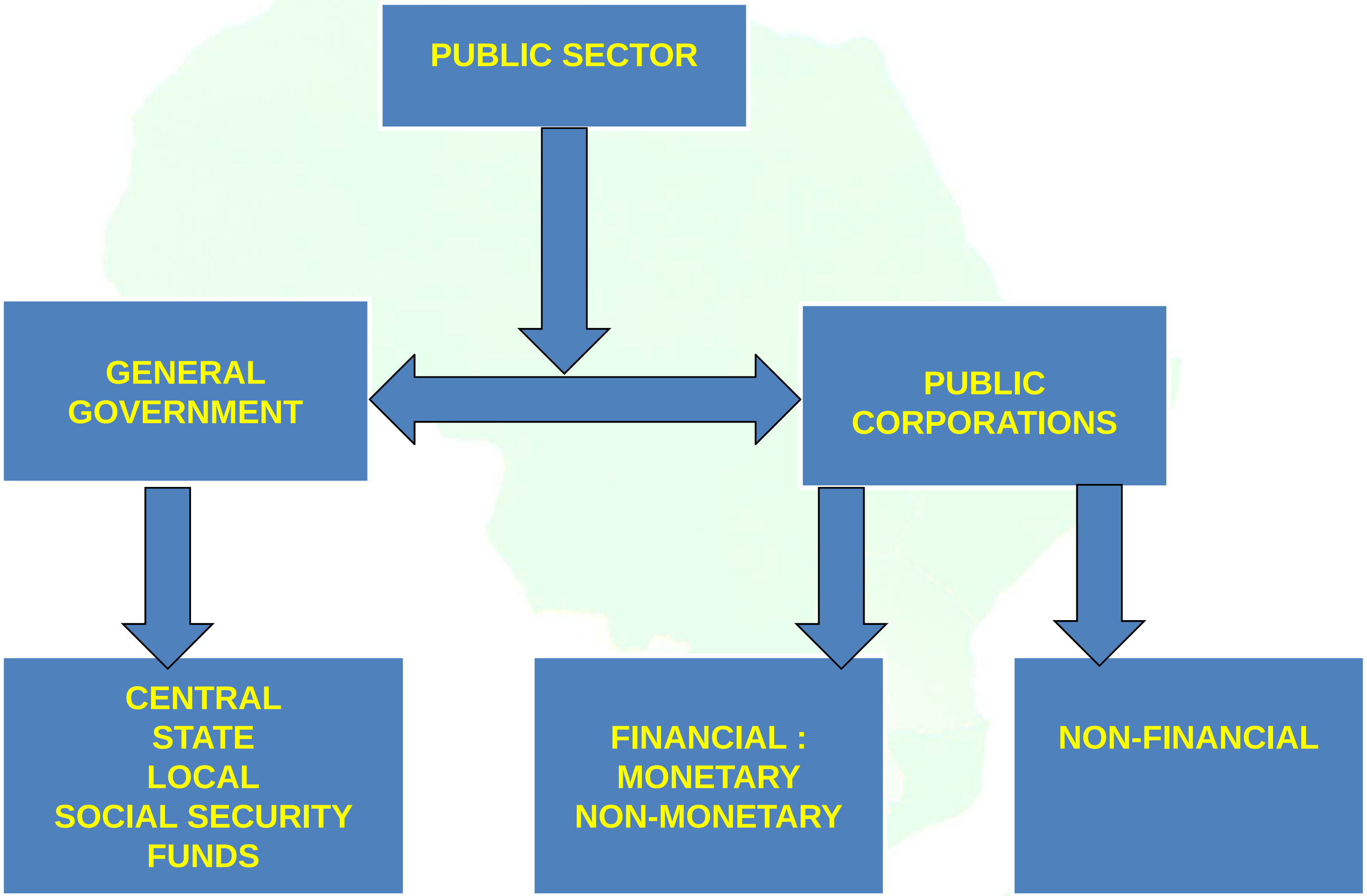
The State-Owned Enterprises (SOEs) could be **classified into various functional sectors/clusters**, e.g. Kenya which assessed SOEs sample in 2007 and 2009 classifies them into.:

- Commercial / Industrial
- Regulatory / Overseeing
- Facilitatory / Catalytic
- Revenue Collection / Administration
- Appeals / Jurisdictional
- Research/Academic/Educational
- Regional/Local Government
- Social (Welfare) Services
- Special Commissions, etc.

The *Public Sector Debt Guide (2011)* structures the Public Sector as comprising (see also next slide):

- **General Government:** Central, State, and Local Governments, including Social Security Funds
- **Public Corporations:** Financial Corporations and including Monetary Authorities, and the Non-Financial Corporations

SCOPE: PUBLIC SECTOR



Source: Public Sector Debt Guide, IMF 2011

Scope (Continued)

Contingent Liabilities in the region, from central government perspective, transcend:

- **Guarantees:** loans / overdrafts, exports (e.g. ECGC), supply contracts, leases and their related penalties for any defaults/arrears
- **Non-guaranteed financial instruments:** Loans, supply contracts, leases and their related terms per instrument including those based on any letters of comfort/support issued by government
- **Recapitalization** requirements / **uncalled up share capital** from government
- **Utility bills** not settled and/or accumulating – for electricity, communication, refuse, water, etc.
- **Arrears and Commitments to Suppliers** (other than to Utilities) – both accumulated/unpaid and what is pending / escalating

NB: **On-lending** from MOF: not debt but claim ("contingent" asset) from MOF perspective, it is debt of the recipient entities

Scope (continued)

Contingent Liabilities in the region (continued):

- **Statutory Obligations** (not fully met/with delays or exogenous support):
  - **Tax** liabilities (corporate and PAYE, including any penalties).
  - **Pension contributions and obligations** (employer and employee portions): Contributory (defined e.g. to NSSFs) and non-contributory (e.g. Government Scheme: stated at staff appointment)
  - **Insurance premiums** and any **shortfalls towards full insurance of assets and personnel** of the entities concerned
  - For state-owned pension funds and insurance companies – **any actuarial deficits**, including shortfalls in receiving the public sector's contributions and getting these entities to make maturing pay-outs
  - **Employee Terminal Benefits** – due and payable at retrenchment /termination of employment or contracts of staff concerned
  - **Lawsuits/litigations** – court awards with costs & pending litigations

Scope (continued)

Contingent Liabilities in the region (continued):

- State-Owned **Financial Institutions** (commercial banks, development banks/funds, building societies, other credit facilities e.g. for the SME sector):
  - percentage **share of government ownership (unpaid)** and related obligations (e.g. share increase)
  - value of **deposits not covered by any deposit protection scheme** or covered but/**if the scheme itself is weak or not assured (reinsurance)**
  - Any impending, on-going or recent financial sector wide crises / receivership / curatorship (which may also give rise to **bank bail-outs**)
- National Disaster (Preparedness) Related:
  - What would be the cost of **national and natural disasters** from known **diseases / epidemics** (e.g. national drug stores), **weather related** (floods, droughts, frosts, earthquakes, volcanoes, food reserves), **environmental management** including for dealing with national fire outbreaks, etc. Precedents in this regard help potential cost estimation

Scope (continued)

Note on Measurement and Valuation per Public Sector Debt Guide (2011):

- **Complex and evolving**, but worthwhile to **at least keep a register** of contingent liabilities (alongside public debt instruments), for disclosure and transparency
- Guarantees (once-off) on loans and debt instruments should be **valued at nominal value** and **for tradable one at market value**. However there is **risk of overstating the risk** – if at **nominal value** and also because **not all debt usually gets defaulted on**
- **Sometimes the loan guarantee is treated as a contingency (provision made in the budget)** for possible debt assumption – **has moral hazard!** However in other jurisdictions, government assumes debt but still pursues recovery
- Debt assumption may be a) **immediate** at default or b) **gradual**, corresponding to timing per maturity profile as repayments accrue

Background

Background

- **Changing/evolving role of Governments in Africa** – from supplier of some goods and services to facilitator that provides an enabling environment including extending guarantees and support

- **Promotion of private enterprise**, with significant privatization and at least commercialization of the retained State-Owned Enterprises (SOEs), with some of the entities being unbundled into separate specialized business units

- **Some decentralization and devolvement** of what initially had been highly centralized governments, together with responsibilities that require funding, creating public sector liabilities, off central governments' balance sheets

- **Growing infrastructure investment needs** mainly in transport, energy/power supply, and social sector notably education, health and sanitation have seen **growing public sector borrowing requirement (PSBR)**, and also the **roping-in of the lower tiers of government and private sector actors**, including through public-private partnerships (PPPs)

- Recent **Global Financial Crisis and on-going Eurozone Debt Crisis** have seen Governments worldwide, including in Africa, taking a **more interventionist approach** to help their economies weather the attendant consequences: has i**ncreased public spending, hence debt/other liabilities**

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Background (continued)

- **These developments have spurred the growth, sources and character of government direct liabilities and those contingent on the performance of the wider public sector**, including:
  - **Guarantees and non-guaranteed sources**: loans, overdrafts, exports credits, letters of credit, supply contracts, leases, public-private partnerships (PPPs), lending and on-lending, and also use of letters of comfort/support
  - **Recapitalization** requirements / uncalled up share capital in SOEs
  - **Commercial, central and development banking exposures:** e.g. deposit protection, central bank recapitalization, development finance exposure
  - **Statutory obligations:** tax liabilities including PAYE, pension and insurance contributions/deductions including any actuarial deficits for public pensions/insurance schemes, employee terminal benefits, and lawsuits / litigation
  - **Utility bills** - arrears and new accumulations
  - **Arrears and commitments to suppliers** of goods/service (other than utilities)
  - National-level **natural or environmental disaster preparedness related** liabilities, e.g. due to weather, pandemics, fires, etc.

- Consequently, **Governments have needed to incorporate contingent liabilities into their fiscal surveillance frameworks,** alongside effective management and monitoring of conventional government debt, to better account for all liabilities giving rise to fiscal risk exposure on balance sheet

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Background (continued)

- **Efforts relating to Sovereign Assets and Liabilities Management and Contingent Liabilities in the MEFMI Region** date back to:

  – The predecessor of MEFMI, the Eastern and Southern African Initiative on Debt and Reserves Management **(ESAIDARM), initiated to close the gap** between the then debilitating **external debt** problem, and meagre **foreign exchange reserves**. Countries were encouraged to monitor government-guaranteed and private sector external debt and to capture these and government external debt in computer-based debt management systems (CBDMS) - and accommodate in them in reserves management. **Helped restore external debt sustainability**

  – Introduction of **Sovereign Liability Risk Modelling and Quantitative Financial and Statistical Calculations training into MEFMI Regional and Fellows Development curriculum** since late 1990s: Culminated in first ever MEFMI regional assessment in 1998 of state of sovereign ALM: **Raised awareness: conservative/passive risk averseness (& debt accommodated)**

  – Steps taken over 2007-2010 to **translate knowledge/skills into a Sovereign Liability Risk Model in one test MEFMI country**, and **subsequently taking on medium term debt strategy (MTDS) analytical tool** of BWIs for rest of countries. Model combined public debt data from CBDMS and others, macro data/forecasts that determine government funding requirements and alternative funding strategies designed and tested under market scenarios for interest and exchange rates: **Cost-and-risk indicators that guide MTDS formulation**

Background (continued)

- However, there are **still challenges to implementing** effective contingent liabilities management and oversight arising from:
  - **Dependence on willingness** of the many individual public sector actors to fully disclose all their liabilities
  - **Complexity due to many sources and forms of the liabilities**, where governments may have a choice of instruments to use e.g. direct borrowing and spending, issuance of guarantees or letters of support/comfort to state-owned enterprises or private actors, extending lending or on-lending to them, or, where feasible, leaving SOEs to make own funding arrangements without direct /explicit government support. Financial SOEs may also have actuarial (pension/insurance) and recapitalization related liabilities, including for deposit protection schemes and central banking functions
  - **Weaknesses in legal and institutional frameworks** governing creation and use for contingent liabilities, transcending the expertise, procedures and criteria for application, assessment, approval, monitoring/recording, and reporting/disclosure of the various contingent liabilities at the different levels of government and public sector entities. Fragmented departments
  - All this limits any provisioning for contingent liabilities in national budgets: **the culture is yet to change**

Background (continued)

- Debt Management Performance Assessment **(DeMPA)** has highlighted other **related challenges** in many African countries, such as:
  - **Inadequate specification in primary or secondary legislation** of **purposes** and **ceilings** for guarantees and on-lending, and limited seeking of necessary **Parliamentary approval** and also **regular reporting** back and **disclosure**
  - **Absent or inadequate policies, strategies, and documented procedures/ guidelines** for issuance, risk assessment for any fees/rates charged, and post- issuance monitoring and reporting/disclosure. Thus, **no clear criteria** for choice made between issuance of guarantees or letters of support/comfort, lending or on-lending, subsidies/grants, public-private partnerships (though quite nascent), or authorization of state-owned enterprises to make own funding arrangements outside of government support
  - **Limited/fragmented managerial & coordination structures** (often no principal entity) for issuance, assessment, fiscal risk & compliance monitoring, recording in proper debt system, auditing (performance) & guarantees reporting/disclosure in Public Sector Debt management context
  - **Limited or no inclusion of the likely-to-be-called-up segment** of guarantees in debt sustainability analysis (DSA) & MTDS' cost/risk analysis

Methodology and Tools

Methodology and Tools

Methodology:

- **Three-step:**
  - **Share and tape the OECD experiences** along those of South Africa (mid-2013)
  - **Assess and compile MEFMI experiences/situation with recommendations** – was preceded by Zambia test case assessed by MEFMI/UNCTAD (on-going)
  - **Convene a joint Regional Dissemination Workshop** in first half of 2014

- **Participation for the countries - guided by MEFMI**
  - Aim is **to initiate a process that will be sustained and owned** by member States, hence work through Ministries of Finance and national resource persons
  - Seek **to cover all entities concerned** (state owned enterprises and local authorities) or **at least assess a sample** (representative of sectors, types & sizes)

- **Regional consolidation of outcomes by MEFMI**
  - **Caters for confidentiality** of country and entity specific information gathered
  - **Deduces emerging trends/patterns** and also identifies policy, institutional, informational and expertise **gaps** for both governments and the targeted entities
  - **Fosters intra-regional MEFMI comparison and with OECD and RSA**: benchmarking for better policy, and legislation, institutions including procedures

Methodology and Tools (continued)

Tools / Inputs

- Reference **OECD study** report
- **Zambia experiences** (study by MEFMI/UNCTAD)
- **Questionnaire** agreed amongst OECD, RSA Treasury and MEFMI
- Launching/Guidance **Missions**:
  - **Elucidation** of the questionnaire
  - **Elaboration** of the what liabilities to capture
  - **Demonstration** of how to administer the Questionnaire through sample interviews with one or two entities in each country

Methodology and Tools (continued)

Implementation Challenges and Opportunities so far:

- **Time Constraint** to Completion due to bureaucratic red tape in Ministries and time required by entities to assemble their responses
- **Dearth of Expertise** – new area for most member States' officials with limited prior experience in contingent liabilities management and no consolidated data / information or focal departments/units in the Ministries
- **Few countries have external guaranteed loans in computer-based debt management systems**, but **hardly have on on-lending and other liabilities**
- Some SOEs **do not have recent financial statements** although many have management accounts: cite financial resource constraints mostly
- There are **confidentiality concerns** by both governments and the entities – allayed by assurances that information will be consolidated
- Mix of **raised SOE expectations** that governments will address their needs and **fears that governments and IFIs plus rating agencies are now scrutinizing** SOEs/LAs more - requires explaining assessment rationale

Expected Outcomes

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Expected Outcomes

- Some **sense (estimate) of the stock** of contingent liabilities and governments' **approaches to managing** them:
  - Will **require further work** to more accurately measure the liabilities over time by **gradually instilling a culture of reporting/disclosure** in both targeted institutions and MoFs' relevant departments

- **Recommendations** for better management of the liabilities, including:
  - Enhancing **legal frameworks**
  - **Containing the liabilities' growth**
  - Greater **consolidation, centralization and/or coordination** of the institutional arrangements, & **documented procedures/guidelines** for:
    - Pre-approval analysis and approval **(front office)**
    - Down-stream risk monitoring and analysis relative to the sovereign balance sheets (ALM), DSA and MTDS **(middle office)**
    - Regular reporting/disclosure of all contingent liabilities **(back office)**
    - **Anticipating** (proportion likely to materialize) and **meeting the costs**, alongside pointers for **reform** of SOE sector, as appropriate

Anecdotal Evidence and Emerging Lessons

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Anecdotal Evidence and Emerging Lessons

It is **still too early into the MEFMI study** to make firm conclusions. However, anecdotal evidence seems to suggest that:

- Government **guarantees significantly exist**, along with letters of comfort/support, loans, on-lending, and other liabilities, with SOEs and local authorities (LAs) being in arrears on some of these and statutory obligations
- Some governments own **sizable shares** in commercial / deposit-taking institutions, national development banks, public pension/insurance schemes
- There are traces of consolidated/amalgamated banks, including some central **bank recapitalizations** or need thereof and **no deposit protection**
- **Public-Public Partnerships, though nascent**, **are taking shape** in tandem with enactment of relevant legislation and PPP Units to govern/manage them
- There are some **liabilities in SOEs and LAs that have been or are being reformed, privatized or liquidated**: but banking sector SOEs fair better
- **Lawsuits in the normal course of SOEs' business**, including from ex-employees for terminal benefits, are evident
- SOEs and LAs **do not always timely pay their utility bills and the suppliers** of various goods and services on time
- There are some **inter-SOE liabilities**, hence netting off may be necessary

Anecdotal Evidence and Emerging Lessons (continued)

Some lessons:

- Compared to public debt management, the **legal, institutional and procedural frameworks for contingent liabilities management are generally weak.** However, **awareness** of the need to enhance these **is now growing**
- Lack of procedures and criteria for up-front credit risk assessment and application of market-based approach in determining applicable guarantee fees or on-lending interest rates in contingent liabilities leaves **too much leeway for discretion and has the moral hazard to perpetuate dependency** on government support even in sectors where privatization would be best
- **What is explicit contingent liabilities for SOEs may be implicit for central government,** and in some cases **has become current/actual liabilities for governments**. Hence the **distinction has not been always obvious and is prone to change over time**. **Lack of risk monitoring and classification** during the life of the liabilities has not helped the situation
- Too much **bureaucracy in accessing SOEs information can preclude effective and timely reporting** for monitoring/disclosure, especially at start
- **Are governments and the SOEs readily willing to open up to scrutiny**, considering the pros and cons of doing so? Is there no potential **conflict of interest or too much official secrecy** and confidentiality?

Conclusion and Way Forward

Conclusion and Way Forward

There is need to pursue best practice: for Legal Framework this holds if it:

- Is **consolidated** than fragmented: both in the Constitution and enabling Acts
- States guarantee/liabilities issuance **authority** (Minister, and delegation)
- Defines **roles, obligations & penalties** of all institutional players in entire liabilities cycle: Legislature, Lawyers, Minister/Executive, DMO, Auditors, Public Corporations (incl. those Guaranteed and the Central Bank), and Sector / Line Ministries
- Lists **objectives, incl. fund-raising, lowest possible cost & prudent risk**
- Requires inclusion in **strategy** (ideally debt strategy) and policy guidelines
- Covers **all relevant liabilities**: debt, guarantees, on-lending and arrears
- States and restricts **purposes** for issuance of guarantees and other liabilities to most relevant sectors, e.g. where private entry has economic/social barriers
- Sets some **limits/ceilings** and **pricing guidelines** for liabilities and **consequences** of their breach
- Requires **audit of performance** (in relation to the law, strategy, and procedures and also related financial and ICT systems)
- Requires **reporting to the Legislature** and also to wider audience (via disclosure of liabilities information e.g. posted to website)

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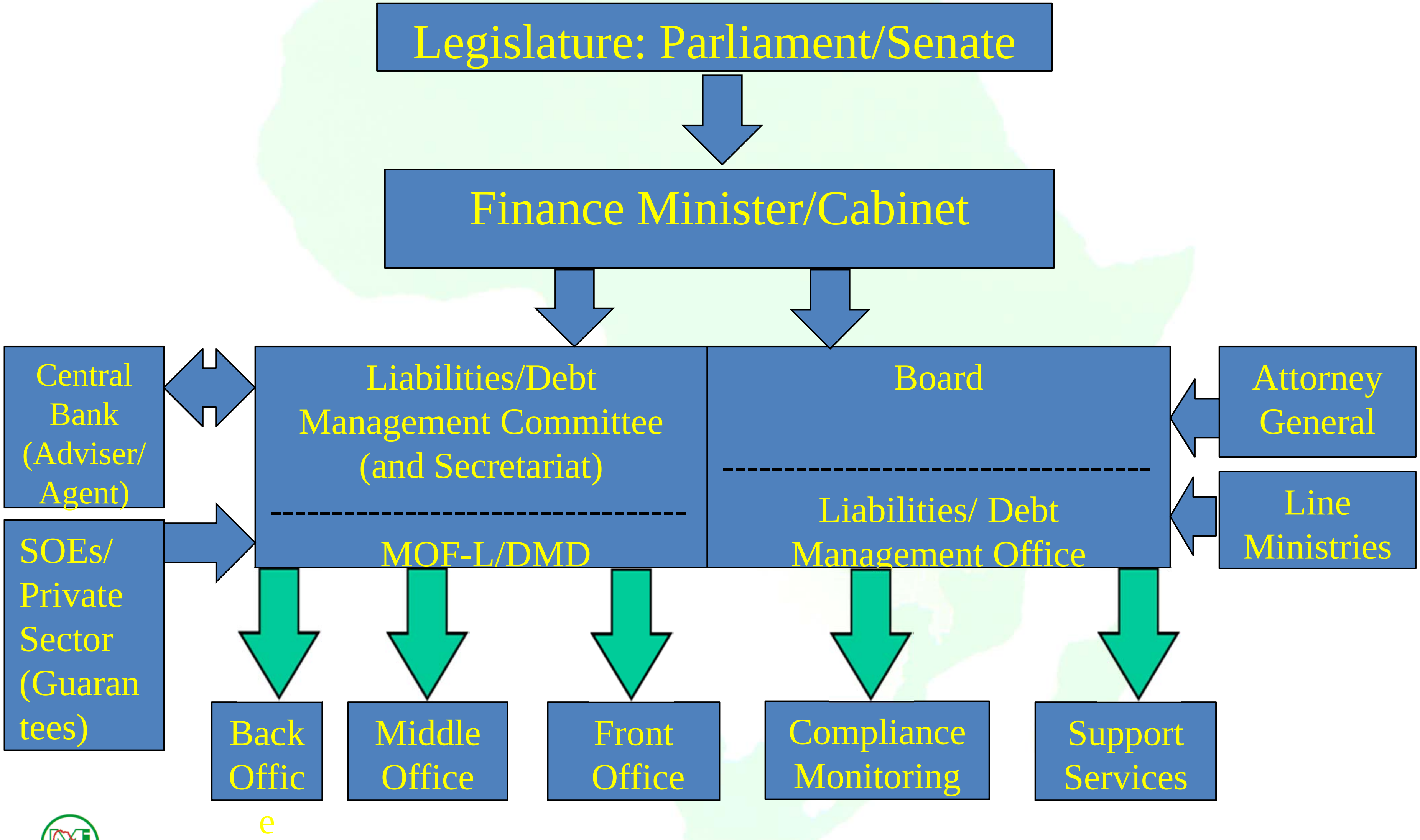
Conclusion and Way Forward (continued)

From Institutional Best Practice perspective:

- There should be **Parliamentary** delegation &oversight
- The **Attorney General's Chambers** aught to be appropriately involved
- The role of the **Finance Minister** should be adequately delegated, authorized and accountable
- The **roles and coordination mechanism amongst all players** (Ministry of Finance departments, line/sector Ministries, Attorney-General's Offices, Auditor-General's Offices, state-owned enterprises)**,** should be clearly defined (see next slide)
- There should be an approved **organization structure and formalized mandate** for its operationalization
- There is need for documented and approved **guidelines/ regulations/ procedures** for all functions: front, middle and back office
- Internal and external **audits should be undertaken** regularly and comprehensively (i.e. performance audit)
- Timely and regular **disclosure/publishing of the information**
- There should be **budget provisioning for likely-to-materialize liabilities**
- Determine **sectors/activities not for SOEs** – i.e. where private actors are best

Institutional Framework (Example)



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Conclusion and Way Forward (continued)

Contingent Liabilities Management Frameworks should engender:

- Defined **law and objectives** in line with best practice (funding, cost and risk)
- Comprehensive **coverage** of relevant liabilities within central government's control and ultimate responsibility: information, analysis and strategy should cover these
- Effective **coordination** of with fiscal and monetary policies and operations, with clear definition of institutional and policy mandates
- **Transparency and accountability**, as seen in professional integrity, performance audit and regular public disclosure of objectives, mandates/roles, obligations, operations and performance in contingent liabilities management
- **Authorities** – both legal and institutional – should be known and clear to all stakeholders for each player, covering front office (application, issuance and debt assumption), middle office (analysis and strategy-formulation) and back office (settlement and record-keeping and debt reporting) operations
- **Management of internal operations** should cover all performance areas and address the legal, operational and financial (market, rollover, liquidity, credit, settlement) risks that the business entails. It should be guided by a professional code-of-conduct and appropriate systems and approved operational procedures
- **Strategy** (qualitative/quantitative) should be in place, with risks of the portfolio risk measured, managed and evaluated within overall debt sustainability analysis (DSA), MTDS and government ALM plus cash management and forecasting

Key Message:

"Understand, Regulate, Assess, Monitor, Disclose"

The End ……………..Thank You !

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