

# STRATEGY AND RISK MANAGEMENT: NATIONAL TREASURY OF SOUTH AFRICA

## *RISKS RATING METHODOLOGY, INDICATORS AND MEASUREMENTS*

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**national treasury**

Department:  
National Treasury  
REPUBLIC OF SOUTH AFRICA

# CREDIT RISK'S AND THEIR MITIGATION STRATEGIES

## 1. COUNTERPARTY RISK: THE INVESTMENT OF SURPLUS CASH

- Monitoring and evaluation of the banks through analysis of the annual reports outlining the risks associated with the investment of surplus cash with the big four banks. Through this analysis, determine counterparties to be approved as well as limits and ratios per counterparty.
- Monitor the adherence by the cash management directorate on the prescribed ratios and advice on any deviations and the impact thereof.

# CREDIT RISK'S AND THEIR MITIGATION STRATEGIES

## **2. SETTLEMENT RISK : EIGHT PRIMARY DEALERS**

- Identify any possible risks that are likely to pose risks on the operations of the primary dealers and bring them to the attention of management for decision making in terms of the weekly auction allocations and in ensuring that they deliver on their obligations.
- Monitor the banks EDFs and advice on any likelihood of a default by a particular bank given its operations and the environment in which it operates.
- Monitor and observe any rating actions taken against a particular bank and its future impact on being part of the primary dealer panel.

# CREDIT RISK'S AND THEIR MITIGATION STRATEGIES

## 3. CONTINGENT LIABILITIES

### 3.1. Explicit Guarantee Portfolio

- Assess the guarantee portfolio on an annual basis and highlight any possible and future challenges that pose risks to the quality of the overall guarantee portfolio.
- Give advice to the fiscal liabilities committee on a quarterly basis on the state of the contingent liabilities and alert the forum on any improvement or deterioration on the overall guarantee portfolio.
- Monitor our sustainability measure of net debt, provisions and contingent liabilities as a percentage of GDP against a limit of 50 per cent.

# CREDIT RISK'S AND THEIR MITIGATION STRATEGIES

- Monitor the credit spreads of the guaranteed SOCs and report on a weekly basis outlining the rate at which it will cost the SOCs to raise debt on their respective bonds in the capital markets.
- Monitor the credit ratings assigned to the respective SOCs on a frequent basis and substantiate on the risks that are likely to impact on their future borrowings and advice on the actions that these entities need to implement in their operations.
- Monitor the SOCs debt composition and give highlights on whether it has deteriorated or improved.

# CREDIT RISK'S AND THEIR MITIGATION STRATEGIES

## **3. CONTINGENT LIABILITIES (cont...)**

### 3.2 Implied Implicit Contingent Liabilities

- UIF
- RAF
- Compensation Fund
- SASRIA
- ECIC.

## **4. PUBLIC PRIVATE PARTNERSHIPS (PPPS)**

- Analyse and report quarterly on the amount and quality of government's exposure to PPPs through analysis of probability of termination of respective contracts.

# 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.

# RISK RATING TABLE FOR BANKS

<b>Weight (%)</b>	<b>Scale</b>	<b>Consideration</b>
<b>20</b>	<b>1-10</b>	<b>Capital Adequacy</b>
<b>10</b>	<b>1-10</b>	<b>Return on Equity</b>
<b>10</b>	<b>1-10</b>	<b>Return on Asset</b>
<b>10</b>	<b>1-10</b>	<b>Debt/Assets</b>
<b>10</b>	<b>1-10</b>	<b>Efficiency Ratio (cost-to income)</b>
<b>10</b>	<b>1-10</b>	<b>Market Position and Operational Environment (JSE mkt cap)</b>
<b>5</b>	<b>1-10</b>	<b>Management and Track Record (government support: good)</b>
<b>10</b>	<b>1-10</b>	<b>Credit Rating</b>
<b>15</b>	<b>1-10</b>	<b>JSE Performance</b>
<b>100</b>		<b>Score</b>
		<b>Overall Rating</b>
		<b>Risk Class</b>

Source: National Treasury



# RISK INDICATORS FOR SOCs

Business Risks	Financial Risks
<p><b>Industry Prospects</b></p> <ul style="list-style-type: none"> <li>- Operating Environment</li> <li>- Regulatory Framework</li> </ul> <p><b>Corporate Governance</b></p> <ul style="list-style-type: none"> <li>- Adherence to PFMA</li> <li>- Management Quality</li> </ul> <p><b>Market Position</b></p> <ul style="list-style-type: none"> <li>- Diversification</li> <li>- Size</li> </ul>	<p><b>Profitability</b></p> <ul style="list-style-type: none"> <li>- Cost to income ratio (DFIs)</li> <li>- Net profit margin</li> <li>- EBITDA margin</li> </ul> <p><b>Capital structure</b></p> <ul style="list-style-type: none"> <li>- Debt to assets</li> <li>- Debt to equity</li> </ul> <p><b>Cash flow adequacy</b></p> <ul style="list-style-type: none"> <li>- Funds from operations/Debt</li> <li>- Interest cover</li> </ul> <p><b>Liquidity ratios</b></p> <ul style="list-style-type: none"> <li>- Cash ratio</li> <li>- Quick ratio</li> <li>- Current ratio</li> </ul>

Source: National Treasury

# FINANCIAL RISK INDICATORS AND BENCHMARKS

	Risk Ratings	1	2	3	4	5	6	7	8	9	10
	Financial Risk Classifications	Extremely Low	Very Low	Low	Moderate Low	Moderate	Moderate	Moderate High	High	Very High	Extremely High
Scale	Risk Descriptions	Excellent	Strong	Good	Fair	Acceptable	Marginal	Special Attention	Substandard	Doubtful	Known Loss
1-10	Net Profit Margin	>30	28-30	25-27	22-24	19-21	16-18	13-15	10-12	6-9	<6
1-10	Operating profit margin	>50	46-50	41-45	36-40	31-35	26-30	21-25	16-20	11-15	<10
1-10	Cost-to-income	<10	10-19	20-29	30-39	40-49	50-59	60-69	70-79	80-89	>90
1-10	EBITDA Margin	>50	45-50	40-44	35-39	30-34	25-29	20-24	15-19	10-14	<10
<b>Capital Structure</b>											
1-10	Debt ratio (Debt/Assets)	<10	10-19	20-29	30-39	40-49	50-59	60-69	70-79	80-89	>90
1-10	Gearing ratio (Debt/Equity)	<0.50	0.51-0.6	0.61-0.7	0.71-0.8	0.81-0.9	0.91-1	1.1-1.2	1.21-1.3	1.31-1.4	>1.4
<b>Cash Flow Adequacy</b>											
1-10	Funds from operations/Total debt	>50	45-50	40-44	35-39	30-34	25-29	20-24	15-19	10-14	<10
1-10	Interest Cover	>2	1.8-1.9	1.7-1.79	1.6-1.69	1.5-1.59	1.4-1.49	1.3-1.39	1.2-1.29	1.1-1.19	<1
<b>Liquidity</b>											
1-10	Cash ratio	>0.65	0.61-0.65	0.56-0.60	0.51-0.55	0.41-0.5	0.36-0.40	0.31-0.35	0.26-0.3	0.21-0.25	<0.21
1-10	Quick ratio	>1.8	1.61-1.8	1.41-1.6	1.21-1.4	1.01-1.2	0.81-1	0.61-0.8	0.41-0.6	0.21-0.4	<0.20
1-10	Current Ratio	>3	2.8-3	2.4-2.7	2.1-2.3	1.8-2	1.5-1.7	1.2-1.4	0.9-1.1	0.5-0.8	<0.5
1-10	Credit Rating	AAA	AA	A	BBB	BB	B	CCC	CC	C	D

Source: National Treasury

# APPLICATION OF THE METHODOLOGY

Criteria	Weight	Weight with	Weight without	Entity Fiscal Year	Strategic Importance	Priority Methodology	
		credit rating	credit rating			Risk Priority	Ease of Measurement
<b>Qualitative Analysis</b>							
Industry prospects	60	0.050933786	0.050547599	0	5	4	3
<i>Corporate governance</i>							
i) adherence to the PFMA	100	0.084889643	0.084245998	0	5	5	4
ii) Management quality	75	0.063667233	0.063184499	0	5	5	3
<i>Market Position</i>							
i) diversification (in core business)	75	0.063667233	0.063184499	0	5	5	3
ii) size (relative to the market)	60	0.050933786	0.050547599	0	5	4	3
<b>Financial Risk Profile</b>							
Profitability ratio (profit margin)	80	0.067911715	0.053917439	0	5	4	4
Operating income as % of business (sales)	100	0.084889643	0.105307498	0	5	4	5
cost to income	64	0.054329372	0.053917439	0	4	4	4
EBIT/sales	64	0.054329372	0.053917439	0	4	4	4
<b>Capital structure</b>							
Total debt/total debt + equity (debt/assets)	100	0.084889643	0.105307498	0	5	5	4
Debt to equity (gearing)	100	0.084889643	0.105307498	0	5	5	4
<b>Cash flow adequacy ratios</b>							
Funds from operations/total debt	100	0.084889643	0.105307498	0	5	5	4
debt service coverage ratio (interest cover)	100	0.084889643	0.105307498	0	5	5	4
Credit rating	100	0.084889643		0	5	4	5
total with credit rating	1178	1					
total without credit rating	1078		1				
weighted risk rating							
<b>Exposure in millions</b>							
<b>proportional exposure</b>							
weighted risk rating in proportion to exposure							

Source: National Treasury

# MEASURE

- The Expected Default Frequency (EDF) of an entity is a measure of an entity's probability of default at a given time.

	1-Year	5-Year
Expected Default Frequency (EDF)	1.07%	6.31%
Bond Default Rate Mapping	Ba1.edf	Ba2.edf
Percentile	46.96%	48.25%

  

EDF	1-Year	2-Year	3-Year	4-Year	5-Year
Cumulative	1.07%	2.31%	3.62%	4.95%	6.31%
Forward	1.07%	1.25%	1.33%	1.39%	1.43%
Annualized	1.07%	1.16%	1.22%	1.26%	1.30%

Source: Moody's KMV

**THANK YOU**